Breaking down barriers: China investment has never been easier

RMB Investors Forum Whitepaper

Here for good

Foreword

On behalf of Standard Chartered, I am pleased to present the results and analysis from the RMB Investors Forum 2019. Now in its fourth year, our annual survey on China investment gathers the views of participants in multiple markets and job functions across the complete investment cycle.

From our conversations with clients, partners and regulators we know the opening of China's markets to overseas investors has created a unique combination of opportunities and challenges. It was for this reason that we set up the RMB Investors Forum in 2016 with the aim of tracking and assessing the evolving investor response to China investment, and using that research to educate and inform the investment community.

The latest survey gathered responses from 131 investors, regulators, custodians and brokers from across Asia, Europe and North America. From the level of investor confidence in China to how regulatory changes are influencing investment strategy, the survey delivers insights on the major issues impacting China market access.

The results of the survey were used as the basis for a roundtable discussion in Hong Kong that brought together participants from across the investment cycle to consider the findings, and share their observations and experience with us. The discussion helped to inform and develop many of the findings in this whitepaper.

Key findings

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

- Investors continue to focus very strongly on China: as a leading growth market and strategic priority in Asia.
- In 2018/19 investor confidence has moderated slightly, with 86 per cent of respondents now investing in China, a year-on-year drop of two percentage points and the first fall since the survey launched.
- Retail investors now make up a significant portion of investment flows in a number of markets (including Hong Kong, Korea, Europe and ASEAN) showing that China is increasingly an "easier sell" to retail investors.
- Trade tensions between the United States and China is the main reason investors are choosing to pause or reduce their investment. However, the impact is expected to be short-lived.
- Managing currency exposure is now the main practical barrier to investors accessing China markets with a combined 48 per cent of those surveyed citing FX risk or funding challenges as a top concern.
- Stock Connect and Bond Connect remain the core access channels, with 59 per cent of investors using Stock Connect and 53 per cent using Bond Connect. However, investors continue to take a multi-channel approach with offshore bonds, CIBM Direct and RQFII also polling strongly.
- Wholly-owned foreign enterprises (WFOEs) will be key to investors' China strategies, with 45 per cent of respondents either having or planning a WFOE.

I would like to take this opportunity to thank the investment professionals who took part in the survey and the roundtable discussion. Your valuable insights were integral to the creation of this report and Standard Chartered looks forward to partnering with you to deliver the solutions and support that advance access to China's markets.

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

Special acknowledgement and thanks to consultant Barnaby Nelson, an industry expert on market developments in China, for his contribution to this report. Through his 15 years in Asia, he has led numerous industry initiatives aimed at driving the internationalisation of the Chinese financial markets. Working in close co-operation with global regulators, exchanges and market bodies he led regulatory approvals for the Hong Kong – China Connects above all.

Awards and Achievements

GLOBAL FINANCE	Global Finance World's Best Sub-custodian Banks 2019	Regional Winner: Middle East 11 Country Awards: Bahrain, Ghana, Hong Kong, India, Indonesia, Malaysia, Mauritius, Oman, Pakistan, Philippines and Vietnam.
	Global Custodian (GC) Major Markets, Emerging Markets, and Frontier Markets surveys for 2018	Won 30 accreditations up from 15 in 2017 • Category outperformance in 11 markets • Market outperformance in 10 markets • Global outperformance in 9 markets Improved ratings in 9 markets
	Global Custodian Leaders in Custody Awards 2019 Global Custodian Legend – 2019	'Emerging Markets Continued Excellence for MENA' and 'Best Bank Network Team' Colin Brooks, Vice Chairman Securities Services, Standard Chartered – 2019
	The Asset Triple A Asset Servicing, Institutional Investor and Insurance Awards 2019	19 award wins in total. Wins in 14 markets: China, Malaysia, Vietnam, Indonesia, Philippines, Singapore, Bangladesh, Pakistan, Sri Lanka, Korea, Bahrain, Jordan and Oman. Best Custody specialist: • Africa • Fund Managers Mandates of the Year: • Best Custody Mandate • Best Sub-Custodian Mandate Highly Commended in 4 categories
		Custodian Banker of the Year – Thailand Somruthai Srikanchana Head of Securities Services, Transaction Banking, Thailand
債券通 BOND CONNECT	Bond Connect Anniversary Summit 2019	Top Dealers Award Active Banks Award Top Custodians Award

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Introduction

This year's RMB Investors Forum survey was carried out against a challenging market backdrop for China investment. The ongoing trade tensions between the United States and China have rattled markets across the globe and caused a short-term pick-up in outflows. At the same time, regulatory barriers to China investment are falling and index inclusion is gathering pace for both equities and bonds.

What is clear from the survey results is that investor confidence in China remains robust and the case for investing in China continues to be strong. In addition, regulators are actively responding to the needs of market participants by enhancing access schemes.

The efforts of regulators and exchanges over recent years to liberalise China access is attracting a broader sweep of investors – including a significant showing from the retail sector – and generating new strategies as investor knowledge and sophistication increase.

This trend has been bolstered by the continued efforts of regulators to reform the access channels. And while Stock Connect and Bond Connect still attract the majority of investment flows, the proposal earlier this year to merge and liberalise the Qualified Foreign Institutional Investor (QFII) and its renminbi equivalent (RQFII) shows that China's watchdogs remain committed to improving access across all mechanisms. Importantly, the wave of index inclusions that started last year with the addition of A-shares to the MSCI Emerging Markets Index and has expanded to include the Bloomberg Barclays Global Aggregate Bond Index and the FTSE Global Equity Index Series, has accelerated the removal of regulatory barriers, and played an important role in raising investor awareness.

Of course, challenges still remain for investors wanting to access China's markets. From the survey it is evident that investors want better market infrastructure to help them manage FX risk, with no single access channel yet offering a complete menu of tools for hedging, cross-border transfers and managing liquidity. In addition, index inclusion is yet to deliver the expected inflows to onshore assets, with survey respondents indicating that inclusion is not a major factor influencing their decision to invest.

Despite the obstacles, it is clear that China investment is attracting new investors, products and strategies that will power inflows and spur market reform. Never has it been easier to access China's markets.

Market maturity brings growing sophistication

It's been a remarkable 12 months for advances in China investment with regulators and exchanges stepping up efforts to increase access. Over the past year, China's onshore bonds have been included in a major index, plans have been announced to merge and liberalise QFII and RQFII, and a global custodian has been granted a domestic fund custody licence.

So what has this meant for investor sentiment? Last year marked a record high for investor confidence since Standard Chartered launched the RMB Investors Forum survey in 2016. In 2018, 88 per cent of respondents were investing in China while 76 per cent planned to increase their China exposure. This year, interest in China remains high but there has been a moderation of sentiment with 86 per cent currently investing in China and 72 per cent planning to grow their investments – the first fall since the survey was launched.

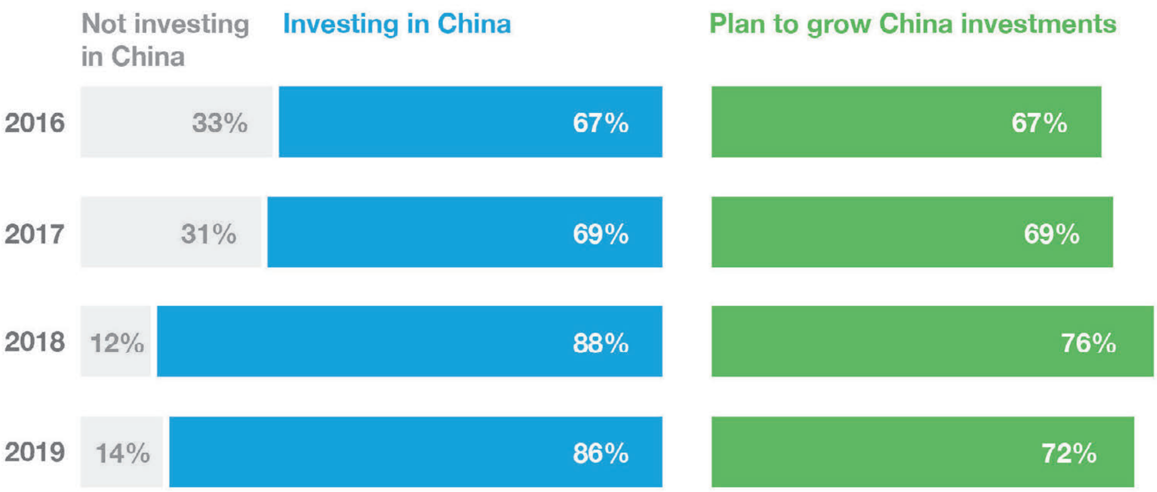
What is clear is that investors continue to view China as a strategically important investment. China remains a top three priority for just over half of investors (51 per cent). While this is an increase on last year's 41 per cent it is perhaps a reflection of the fact that fewer investors now consider China their top strategic priority with the proportion dropping to 12 per cent from last year's 15 per cent.

Investors reach portfolio limits

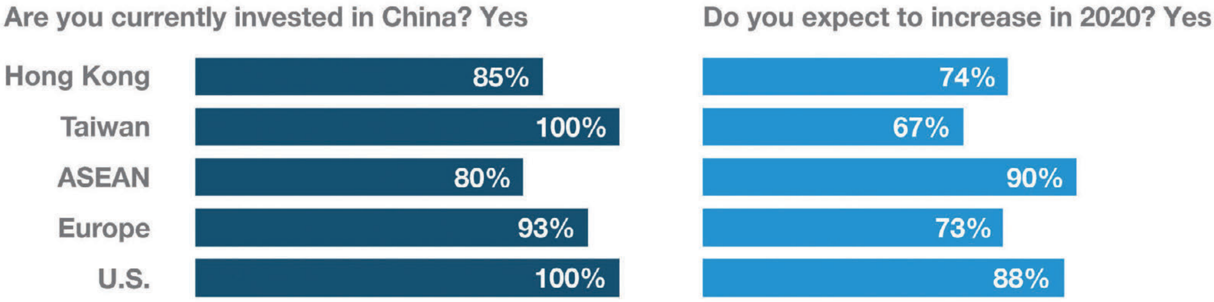
There are a number of factors that may have contributed to the slight cooling of investor sentiment. Firstly, it is important to recognise that many of the earliest investors into China are starting to reach their maximum exposure limits. For example, Taiwanese investors, who have been some of the most active participants in China's onshore market, are subject to a 40 per cent cap on foreign investments in their overall portfolio which limits their ability to take on more exposure to China. This idea is supported by the findings in this year's survey which show that 100 per cent of respondents from Taiwan are currently invested in China but only 67 per cent plan to increase their investments in 2020 (see chart 1.2).

It's not just Taiwanese investors that have a long track record of investing in China. After all, many of the access channels have been operating for a number of years. The RQFII programme for instance was first launched in 2011,[1] while Stock Connect opened for trading in 2014.

1.1 Changes to investments in China over the next 12 months



1.2 Changes to investments in China over the next 12 months by market



RQFII has proved particularly popular in Hong Kong which has seen its RQFII quota expanded three times after managing to fully allocate what was previously available.[2]

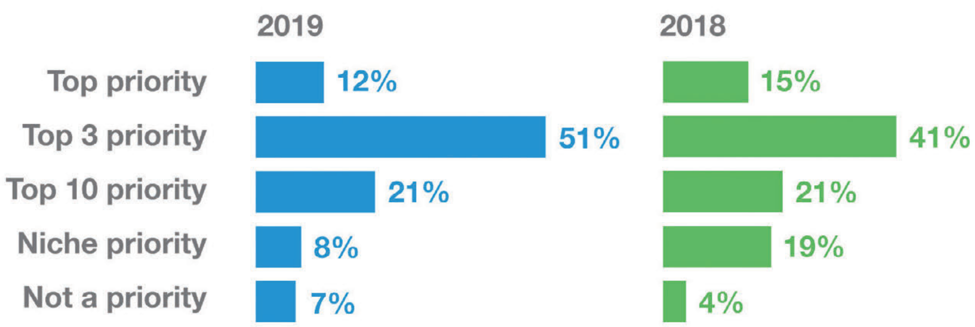
In addition, investors have also told Standard Chartered that trade tensions between the United States and China are affecting their outlook. Fortunately, they are also of the opinion that any impact is expected to be short-lived and does not negate the broader investment case for China.

"On and off there will be sources of tension – if not the trade war then something else. My view is that whether it's US investors or European investors, there is still a strong interest in getting China exposure for diversification or yield. So inflows for China won't be affected for political reasons," said a participant at the roundtable.

There was even some optimism among roundtable participants that the trade war could act as a catalyst for China to accelerate market opening.

"The bright side of the trade war is that it makes China's government look more seriously at how to further open China's markets. If they open up, become more competitive and more market-driven, it's better for the global economy," said a participant at the roundtable.

1.3 The importance of the China market to current investors



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1 CSRC, CSRC Solicits Public Comments on the Measures for the Administration of Domestic Securities and Futures Investment by Qualified Foreign Institutional Investors and RMB Qualified Foreign Institutional Investors (Consultation Paper) and the Supporting Rules, 31 January 2019, http://www.csrc.gov.cn/pub/csrc_en/newsfacts/release/201901/t20190131_350605.html

2 HKMA, HKMA welcomes expansion of Hong Kong's RQFII quota, 4 July 2017, https://www.hkma.gov.hk/eng/key-information/press-releases/2017/20170704-4.shtml

Newer markets to drive future flows

While there may be a short-term cooling of sentiment, one of the key findings from this year's survey is a broadening of the investor base and an increasing sophistication in terms of strategy.

Continuing the trend that was observed in the 2018 survey, investment flows into China are originating from a greater number of markets. For good reason, Asia remains a key source of investment capital with the traditional RMB hubs of Hong Kong, Taiwan and Singapore continuing to score highly for investments in China (85 per cent, 100 per cent and 88 per cent, respectively). However, the strongest growth looks set to come from some of the places that have been slower to access China's markets. When asked if they plan to increase China investments in 2020, Thailand (100 per cent), ASEAN (90 per cent) and the United States (88 per cent) delivered the most positive responses.

Interestingly, Europe retains its position as one of the most sceptical regions. Seventy-three per cent respondents in Europe plan to increase their China exposure in 2020, one of the lowest figures recorded in this year's survey, although it's worth noting that this represents a marked increase from last year's 24 per cent. An important development that may have helped to improve European investor confidence was the Central Bank of Ireland's decision to approve UCITS and AIF funds to invest via Bond Connect in March 2019.[3] While the overall trend is moving in the right direction,

[3] Lexology, China Bond Connect: Central Bank of Ireland completes its review, 21 March 2019, https://www.lexology.com/library/detail.aspx?g=5c7b2c09-01df-451c-a970-c638dcb30e3d

the need to adhere to stricter regulations in Europe, especially for funds operating under the UCITS scheme, is one of the reasons investors from the region remain less bullish than in other places, explained Michael Lai, Head of Network Management Asia at Barclays.

"Everything in China is quite different from what European and American markets are used to. Europe has got developed regulations, processes and platforms. Also, European investors tend to be a lot more conservative in the way they think which is probably driven by the regulations we have to adhere in our home market. And those regulations aren't quite compatible with how things work in China," he said.

Retail starts to embrace China investment

As well as revealing a broader geographical interest, this year's RMB Investors Forum survey also shows an expansion of the types of investors that are seeking access to China's debt and equity markets.

As expected, China investment has so far been led by institutional mandates and mutual funds. While that remains the case this year, the 2019 survey shows that retail investors are now making up a growing and significant portion of investment flows. Markets showing meaningful activity from retail client accounts include Hong Kong (27 per cent), Korea (17 per cent), Europe (13 per cent) and ASEAN (10 per cent).

However, what is also clear is Hong Kong's continued position as the most active territory for China investment with the distribution of investment activity evenly split across different types of investment mandates. Indeed, the city's continued dominance as an RMB hub is one of the consistent themes throughout the survey.

Passive strategies gain traction

When it comes to investment vehicle, actively managed real money funds continue to dominate, accounting for 49 per cent of current activity and expected to account for 47 per cent of flows during the next 12 months.

1.4 China investment vehicles by geography

	Hong Kong	Taiwan	Korea	ASEAN	Europe	N. America
Mutual Funds	53%	67%	50%	30%	60%	75%
Institutional mandates	48%	20%	17%	40%	53%	38%
Propriety investments	37%	73%	0%	50%	27%	25%
Managed accounts/ private trusts	32%	0%	0%	0%	0%	50%
Structured and wealth management products	32%	7%	0%	10%	7%	0%
Retail client accounts	27%	7%	17%	10%	13%	0%
Other	3%	0%	0%	10%	0%	0%

However, when the results are analysed by job function some interesting trends emerge. For buyers, ETFs look set to play a more important role, accounting for 21 per cent of their investment strategy over the next 12 months, up from the current 19 per cent.

"We're definitely excited about ETFs. In the current year the AUM of our biggest China ETF has increased 50 per cent compared to the beginning of the year, so you can see more investors are interested in accessing mainland China markets through the ETF," said a senior executive from the Hong Kong-arm of a Chinese asset manager.

By country, it's clear from the survey that Taiwan is the main driver of current ETF activity, with passives accounting for 43 per cent of current investment strategy and 54 per cent over the next 12 months. However, passive investment strategies look set to grow in importance in other territories. This is particularly true in ASEAN where respondents forecast it will make up 20 per cent of investments over the next 12 months, up from zero percent this year, and Europe where the proportion is expected to rise from 31 per cent this year to 50 per cent in 2020.

While the much-mooted ETF Connect between Hong Kong, Shenzhen and Shanghai has been postponed indefinitely due to the challenges of aligning the trading and settlement process between the exchanges in each city,[4] many countries are actively working to boost passive investments. For instance, in April 2019, the Japan Exchange Group and Shanghai Stock Exchange announced plans to allow ETFs that link to each market through the creation of feeder funds.[5]

For now, the participants at the Hong Kong roundtable felt that demand for ETFs was mainly driven by institutional investors, with retail investors yet to show a significant take up of passive strategies.

Product sophistication steps up

A second emerging trend from buyer respondents is the expected increase in product creation, which is forecast to account for 17 per cent of strategies over the next 12 months, up from 13 per cent currently. This growth suggests investors are using more sophisticated methods to access onshore assets as they become more familiar with China's markets. For example, in November 2018 J.P. Morgan Asset Management updated the rules governing its China funds to permit an increase in the amount invested through participation notes (P-notes).[6]

China's authorities have also signalled plans to introduce more products for overseas investors. Tools under consideration by the People's Bank of China (PBOC) include foreign exchange hedging and bond repos, said deputy governor Pan Gongsheng, deputy governor at an event in January 2019.[7]

"The PBOC will fully liberalise bond repurchase transactions at the right time and push hard with the utilisation of the market for renminbi derivatives," he said.

The moderation of investor sentiment this year owes more to short-term macroeconomic factors than a weakening of the investment case for China. The country remains an important, strategic market for a growing number of investors that are adopting an increasingly sophisticated approach.

4 SCMP, Hong Kong shelves ETF Connect scheme with China due to technical issues, says SFC chairman, 13 December 2018, https://www.scmp.com/business/banking-finance/article/2177700/hong-kong-shelves-etf-connect-scheme-china-due-technical

5 JPX, Establishment of Japan-China ETF connectivity, 22 April 2019, https://www.jpx.co.jp/english/corporate/news/news-releases/0060/20190422-01.html

6 J.P. Morgan Asset Management, 21 November 2018, https://am.jpmorgan.com/content/dam/jpm-am-aem/asiapacific/hk/en/supplemental/fund-announcement/181121_notice_jpmf_china_fund_and_jpmf_greater_china_fund_eng.pdf

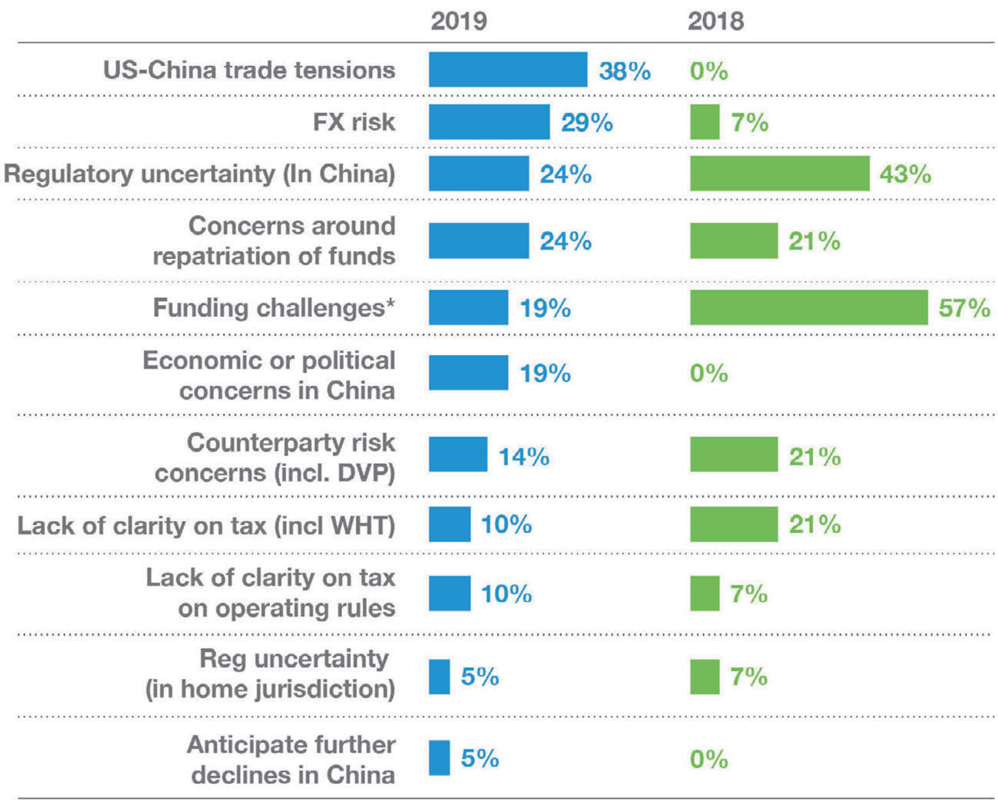
7 China Daily, Wider bond market access for foreign investors, 18 January 2019, http://global.chinadaily.com.cn/a/201901/18/WS5c410a94a3106c65c34e51fb.html

Barriers fall as regulators revise access schemes

It's clear that China remains an important and strategic market with investor sentiment close to record highs. Yet given that this year has seen a slight dip, it is worth taking a closer look at the factors that are making investors cautious. This year there has been a marked shift in the factors influencing the decision to maintain, reduce or avoid investment in China. In a sign of how much has changed over the past 12 months, US-China trade tensions is now the top reason cited by 38 per cent of respondents – a topic that was not an issue under consideration in the first half of 2018.

As comments from roundtable participants in the previous section underline, investors do not believe that the trade tensions hurt the secular investment case for China. However, they are having a short-term impact which was evident by the sharps falls in the Shanghai Composite Index in May 2019 once it became clear that a trade deal was not in sight. In addition, the data from Stock Connect showed that northbound turnover in May and June 2019 recorded double-digit falls.[8]

2.1 Factors influencing investors' decision to maintain/reduce/not invest in China



* CNH liquidity, lack of access to CNY

[8] HKEX, Historical monthly Stock Connect data, May 2019, https://www.hkex.com.hk/Mutual-Market/Stock-Connect/Statistics/Historical-Monthly?sc_lang=en#select1=0&select2=0

More interestingly from the perspective of long-term China access, the change between this year and 2018 of the top concerns shows that the action regulators and exchanges have taken to improve China access and strengthen access mechanisms is paying dividends.

Currency risk causes strain

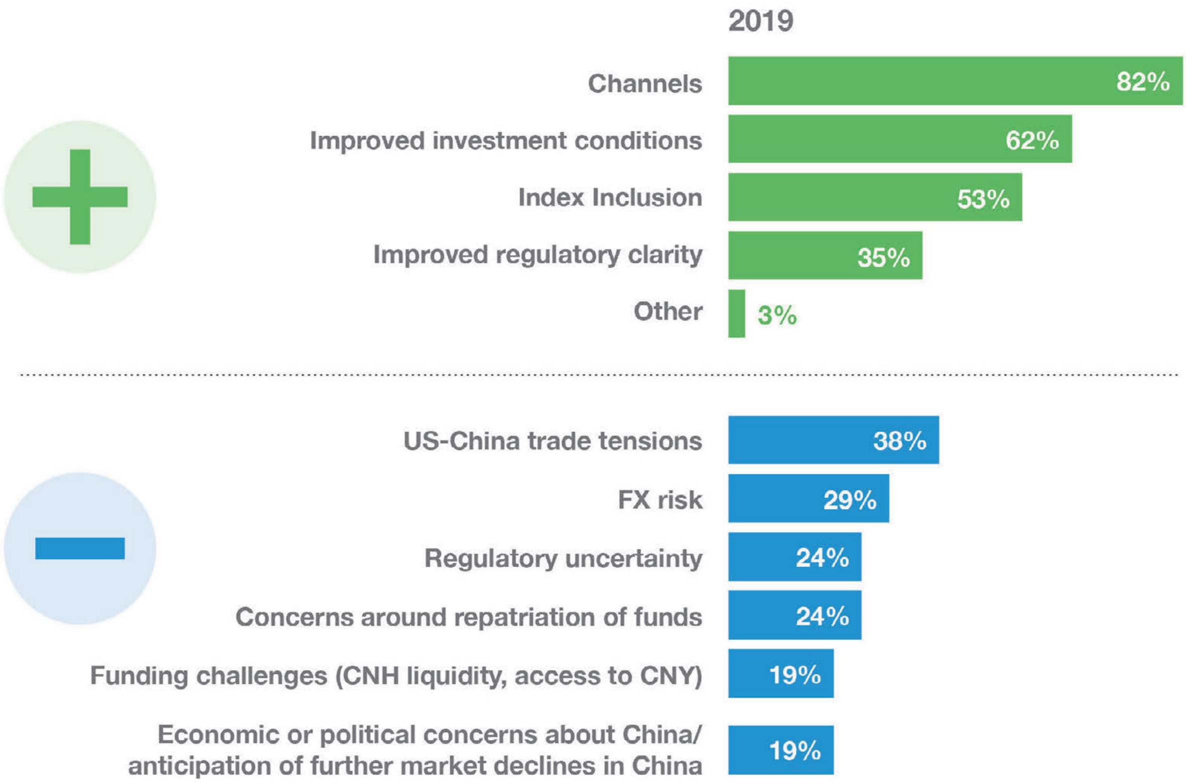
In last year's RMB Investors Forum Survey, the top concern was funding challenges as cited by 57 per cent of respondents. This was in part due to the upcoming MSCI index inclusion and whether there would be enough offshore renminbi (CNH) liquidity to cope with the expected rise in Stock Connect transactions. Fortunately, thanks to the extensive safeguards put in place by China's and Hong Kong's regulators, there was ample CNH liquidity during index rebalancing. One year on, and there has not been a liquidity crunch in CNH, leading to just 19 per cent of those surveyed identifying it as a concern this year.

But even with the specific issue of funding challenges becoming less of a priority, what is clear is that FX risk remains an acute problem. It was the second highest on this year's list, chosen by 29 per cent of those surveyed, up from seven per cent in 2018. This shows that despite regulators addressing issues around the trading and settlement of securities, market development will continue to be stymied without the ability to hedge currency risk, have certainty over liquidity, or move money easily across borders. Certainly, one of the reasons for the popularity of Bond Connect is the fact that it gives northbound investors clear access to their funds, said a roundtable participant.

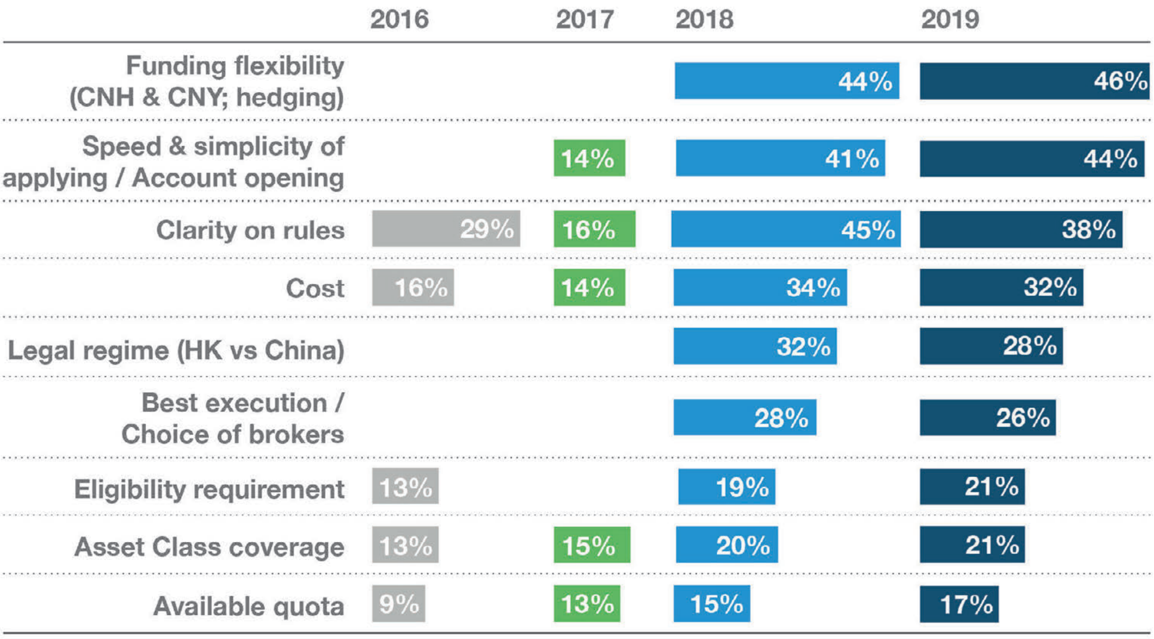
"For people who are far away from China, like in the United States or Europe, the less they understand China the higher the perceived policy risk. That is one of the reasons investors prefer to use Bond Connect so they can keep their cash in Hong Kong," he said.

Meanwhile, the proportion of investors concerned about regulatory uncertainty has also fallen (2018: 43 per cent; 2019: 24 per cent), as regulators respond to feedback from index providers and investors to enhance access schemes. However, it is still the third highest concern for investors and an issue raised during the roundtable.

2.2 Reasons why investors do or do not invest in China



2.3 Important factors for choice of China investment channel



"There are lots of silos in the Chinese government and not much co-operation between them. If all the answers came through one unified voice then it would become a lot easier for us to make a decision," said Shane Spurway, Treasurer, Head of Global Capital Markets, Asia, at Erste Bank.

Access channels trump trade tensions

For all the concerns, as is clear from the high level of positive sentiment, the overwhelming majority of investors are clear about the rationale for investing in China. What remains uncertain is the best way to make that investment. When asked what factors would drive them to start or increase investments in China, 82 per cent cited access channels, followed by improved investment conditions (62 per cent) and index inclusion (53 per cent). This is a continuation of the trend that emerged in the 2018 survey which showed that the development of access channels such as Stock Connect and Bond Connect had done much to increase potential flows to China.

Given that channels remain the biggest driver of investment into China, what are the key concerns among global investors when considering an access channel? For the first time since Standard Chartered launched the survey in 2016, clarity on rules is no longer the top priority, falling to third place with 38 per cent. This is perhaps unsurprising as China's regulators have announced a raft of new measures to enhance the access channels and provide greater certainty.

And as in recent years, many of these clarifications have been driven by index inclusion. For example, the tax treatment of China investments has long been an area where investors felt there was a lot of uncertainty. While Chinese regulators are still to announce a formal policy on tax, in August 2018 the Standing Committee of the State Council announced a three-year tax exemption on bond interest for foreign investors that applied to purchases made through the China Inter-Bank Market, QFII, RQFII and Bond Connect.[9] It is perhaps no coincidence that clarification on tax collection policies was one of the criteria Bloomberg set for bond index inclusion.[10]

[9] PwC, China announces a three-year tax exemption on bond interest for foreign investors, September 2018, https://www.pwccn.com/en/financial-services/publications/fstax-news-sep2018.pdf

[10] 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/

FX is the final frontier

With concerns about regulatory clarity slipping down the rankings, practical considerations now dominate investors' concerns. Top of the list is funding flexibility, reinforcing the fact that FX is one of the final obstacles for China investment. Funding is also a key issue for back office (48%), operations (51 per cent), Hong Kong (51 per cent) and mutual funds (52%).

The currency barriers are notable. Turning to Bond Connect, the problem is one of best execution. Investors are allowed to use CNY but their custodian can only appoint a single bank to carry out FX transactions.

Adding to the challenge is the fact that many global custodians still only offer settlement though Bond Connect in CNH but not CNY. This is a consequence of the fact that when Bond Connect launched, in order for the PBOC to have oversight over both the volume of securities and FX being traded, the structure required that FX transactions be carried out by an FX bank appointed by the local custodian, an arrangement that left global custodians locked out. While last year the PBOC granted China Foreign Exchange Trade System (CFETS) licences to global custodians that allowed them to offer a CNY FX solution, many custodians still do not offer Bond Connect settlement in the currency.

Account opening needs to accelerate

Meanwhile, the second most pressing issue for all investors when considering an access channel was speed and simplicity of application/account opening, which was cited by 44 per cent of respondents.

Unsurprisingly this was also an important issue for back office respondents (46%).

One possible source of this concern is that the inclusion of Chinese debt into the Bloomberg Barclays Global Aggregate Index in April 2019 created a surge in demand for Bond Connect access. As a result, this is leading to a longer than expected time frame for approvals.

Bond Connect surges after index inclusion

But this backlog is yet to dent the popularity of the Connects with 59 per cent of investors identifying Stock Connect as a core investment channel. While this is a drop from last year's 64 per cent, the platform still leads among China investment channels. Bond Connect comes in second place with 53 per cent, a rise from last year's 40 per cent. And this dominance is set to continue in 2020 with 37 per cent of investors planning to use Stock Connect and 22 per cent Bond Connect.

Now almost five years old, Stock Connect last year proved that it was able to cope with index inclusion while recent enhancements include the introduction of an investor ID regime[11] and – on the southbound channel – the ability to invest in dual-class shares.[12]

However, it is Bond Connect that has experienced the biggest changes driven by index inclusion. Bloomberg's criteria for including bonds in its index included implementation of delivery versus payment (DVP), the ability to conduct block trades and clarification on tax.[13] Additional developments such as the approval of Ireland-regulated UCITS to trade though the channel and the appointment of Bloomberg as the second trading platform following Tradeweb have seen Bond Connect set a new blueprint for success.[14]

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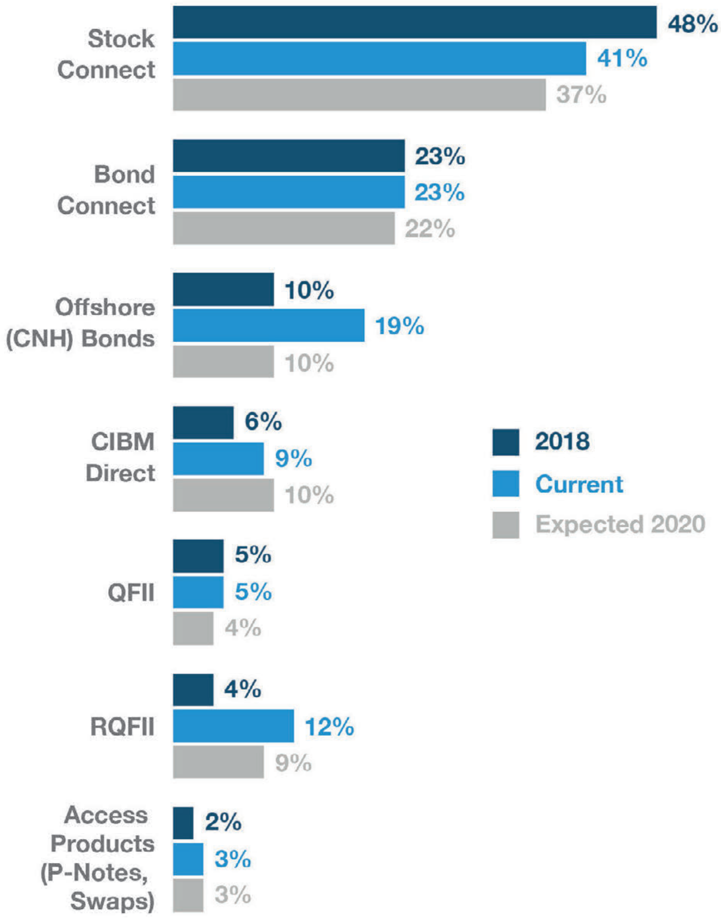
[11] SFC, Launch of investor identification for northbound trading under Stock Connect, 24 August 2018, https://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=18PR99

[12] Bloomberg, China to include dual-class shares in Stock Connect in July, 22 April 2019, https://www.bloomberg.com/news/articles/2019-04-22/china-to-include-dual-class-shares-in-stock-connect-in-july

[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/

[14] HKEX, HKEX welcomes Bond Connect access via Bloomberg terminals, 29 November 2018, https://www.hkex.com.hk/News/Media-Centre/Special/HKEX-welcomes-Bond-Connect-access-via-Bloomberg-Terminals?sc_lang=en

2.4 Current and expected future channels to access China investments



As of May 2019, the number of Bond Connect investors had reached 900 with the average daily trading volume exceeding RMB9 billion.[15] For comparison, in May 2018 the number of Bond Connect investors had reached 300 with an average daily trading volume of RMB3 billion.[16] Of the 900 accounts, 78 per cent have been opened by global asset managers and fund managers, but more significantly, there has been a big shift in the geography of investors. Last year, 66 per cent of accounts were drawn from Hong Kong. In 2019, non-Hong Kong accounts make up 67 per cent of the total, with new jurisdictions now represented including the Netherlands, Sweden and Thailand. This reflects findings in the RMB Investors Forum survey that there is broader geographical interest in Chinese investment.

"For us, Bond Connect is a very smooth and easy operation so in terms of accessing the market we do not face any other problems," said Erste Bank's Spurway.

Hong Kong remains the leading RMB hub

More generally, the strength of the Connects shows Hong Kong's enduring position as the most important RMB hub. Part of this reflects a cultural divide that still exists with most demand for Chinese assets coming from within Asia. And while recent years have seen many other cities keen to position themselves as rival hubs, none has yet been able to offer the same breadth and depth of access. For example, the recently launched Shanghai-London Stock Connect (see box overleaf) has a more limited investment scope than its China-Hong Kong equivalents.

At the same time, Bond Connect and Stock Connect allow investors to keep their funds in Hong Kong, providing an extra level of comfort for accounts that are wary about moving capital into the onshore market.

[15] BCCL, A vibrant May – Bond Connect investors hit 900 market, 16 May 2019, http://www.chinabondconnect.com/documents/NewsRelease_BondConnectInvestorsHit900Mark.pdf
[16] BCCL, Welcome the 300th registered overseas investor of Bond Connect, 8 May 2018, http://www.chinabondconnect.com/docu-ments/Bond_Connect_Registration_News_Release_180508(E).pdf

Shanghai-London Stock Connect

Four years after it was first announced, the Shanghai-London Stock Connect launched on 17 June 2019. Unlike the Stock Connects between Hong Kong and China that allow investors to directly buy listed shares in the respective markets, the focus of Shanghai-London Connect is cross-listings. Huatai Securities became the first company to issue GDRs under the new Stock Connect, raising USD1.54 billion on the same day the scheme launched.[16]

Key facts[17]

- Under the eastbound limb, eligible companies listed on the London Stock Exchange will be able to issue Chinese Depository Receipts (CDRs) to Chinese investors and apply for them to be listed on the Main Board of the Shanghai Stock Exchange. In the initial stages, eastbound companies may issue CDRs representing existing shares.
- Under the westbound limb, eligible companies listed on the Shanghai Stock Exchange will be able to issue Global Depository Receipts (GDRs) to UK and global investors and apply for them to be listed on the London Stock Exchange's Main Market. Westbound companies may issue GDRs representing both existing and newly issued shares.
- In the initial stage, qualified securities institutions can conduct the cross-border conversion of CDRs or GDRs, with an aggregate quota of RMB250 billion for eastbound and RMB300 billion for westbound.
- Securities institutions conducting cross-border conversion can hold cash and other specific classes of assets with the amount of no more than RMB500 million in the other market for the purpose of shortening the conversion cycle and hedging market risk.
- CSRC and the Financial Conduct Authority (FCA) have signed a MoU for further regulatory co-operation.

16 LSEG, Joint announcement by the China Securities Regulatory Commission and the UK Financial Conduct Authority, 17 June 2019, https://www.lseg.com/resources/media-centre/press-releases/shanghai-london-stock-connect-welcomes-its-first-issuer-huatai-securities

17 FCA, FCA and CSRC announce their support for the Shanghai-London Stock Connect scheme, 17 June 2019, https://www.fca.org.uk/publication/mou/joint-announcement-fca-csrc.pdf

Multi-channel approach still the preference

For all the benefits the Connects provide, the unresolved issues around FX and account-opening mean that investors still maintain multiple investment channels to access Chinese assets. This is borne out by the results of this year's survey with offshore (CNH) bonds, CIBM Direct and RQFII comfortably polling between 29 per cent and 38 per cent of investors using them as a core investment channel.

CIBM Direct certainly remains a major channel when you compare the inventory that foreign investors hold though CIBM Direct versus Bond Connect.

There are a number of reasons for this including the fact that CIBM Direct launched earlier than Bond Connect in 2016 and it offers both onshore and offshore currency conversion. In addition, central banks and sovereigns have been able to access the inter-bank bond market since 2013 and those flows are counted under CIBM Direct.

Will RQFII make a comeback?

Investors are also starting to look again at the RQFII scheme. Along with QFII, RQFII is an access channel that has declined in usage and focus since the launch of the Connects. While the schemes have been hampered by the length of time it can take to receive a quota, they do offer a number of benefits. For example, QFII-RQFII holders do not have any restrictions on what securities they can invest in and can also use CNY derivatives to hedge currency exposure.

Specifically, interest has been revived this year following January's announcement by the CSRC that it was considering merging QFII and RQFII, and liberalising the schemes (see box below). Among buyer respondents to this year's survey, proposals to extend eligible assets for QFII/RQFII was the most important policy announced in the last 12 months (79 per cent), followed by third-party FX being permitted on the schemes (76 per cent) and proposals to merge QFII and RQFII (70 per cent).

CSRC proposals for QFII and RQFII[18]

- Consolidate separate QFII and RQFII measures and provisions.
- Relax qualification requirements to remove quantitative criteria, and simplify and streamline the application process.
- Expand the scope of investment to include:
  - stocks quoted on the National Equities Exchange and Quotations
  - bond repurchases
  - private investment funds
  - financial futures
  - commodity futures
  - options.
- Remove the restriction on the number of custodians.
- Enhance ongoing supervision.

2.5 Impact of policies by job type

Policy	Operation	Buyers	Regulatory
Global custodians will be granted a CFETS licence	68%	70%	60%
Proposals to extend the use of securities lending on Stock Connect	71%	70%	70%
Proposals to extend eligible assets for QFII / RQFII	68%	79%	50%
Proposals to merge QFII / RQFII	61%	70%	40%
Third party FX being permitted for QFII / RQFII	64%	76%	50%
Proposals to allow block trading on Stock Connect	68%	70%	70%
Proposals to build a distributed ledger technology on Stock Connect	57%	48%	60%

[18] CSRC, CSRC Solicits Public Comments on the Measures for the Administration of Domestic Securities and Futures Investment by Qualified Foreign Institutional Investors and RMB Qualified Foreign Institutional Investors (Consultation Paper) and the Supporting Rules, 31 January 2019, http://www.csrc.gov.cn/pub/csrc_en/newsfacts/release/201901/t20190131_350605.html

RQFII: The WFOE secret ingredient

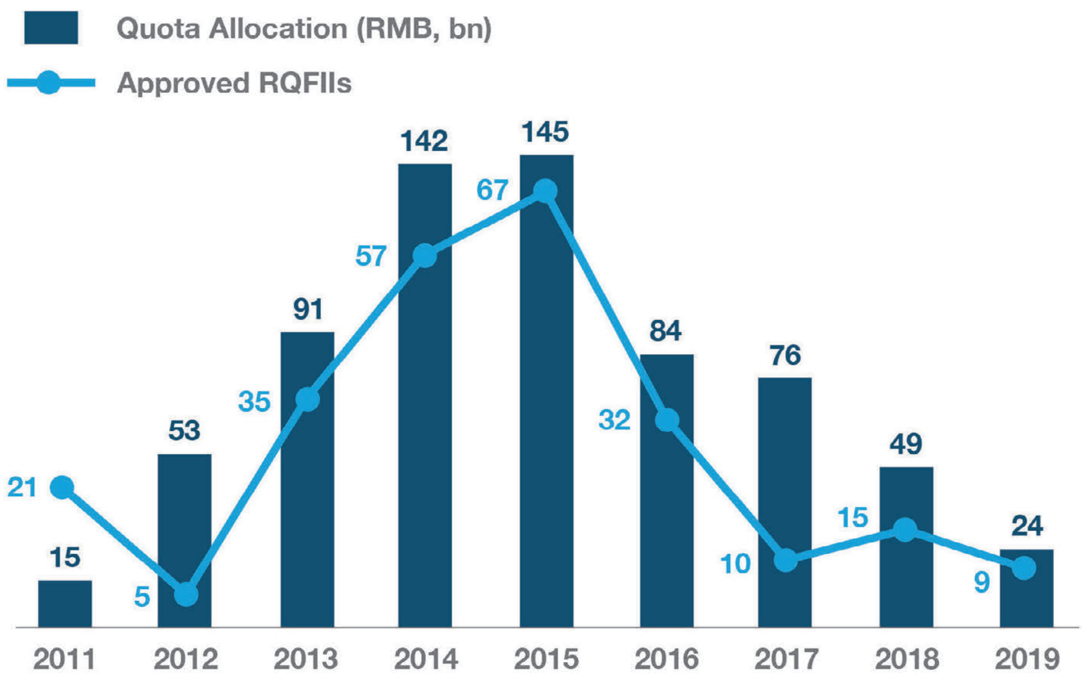
If as seems likely, the CSRC goes ahead with the changes, the merged QFII-RQFII channel (see box on page 17) will provide a near complete set of tools for offshore investors wanting to access China's bond and equity markets, a factor that will become more important as investor sophistication improves.

In addition, while the lengthy application process has proved problematic, many asset managers already have RQFII quotas with the scheme proving popular since it began in 2011. By the end of 2018, the State Administration of Foreign Exchange (SAFE) had granted an aggregate quota of RMB646.7 billion to 233 licence holders.[19] And there has been a sharp increase this year with quotas worth USD4 billion of 12 investors approved during the first four months, more than half of the total quotas handed out in 2018.[20]

And this large volume of existing RQFII quotas could have an important role to play in fund managers' efforts to set up WFOEs in China. For managers that are specifically applying for the private fund management (PFM) licence under the WFOE scheme, the RQFII quota could be the secret ingredient to making it a success.

Under the PFM licence arrangement, fund managers must have launched a fund within six months of receiving the licence and gather assets of at least RMB100 million. However, it has proved difficult for fund managers to build AUM without an existing track record and access to the biggest onshore distribution channels. Under the proposed new rules for QFII-RQFII set out by the CSRC (see box on page 17), fund managers would be able to seed their PFM WFOE funds through their QFII-RQFII quotas.

2.6 RQFII licences and quotas



Source: Standard Chartered research, SAFE

[19] Ibid.

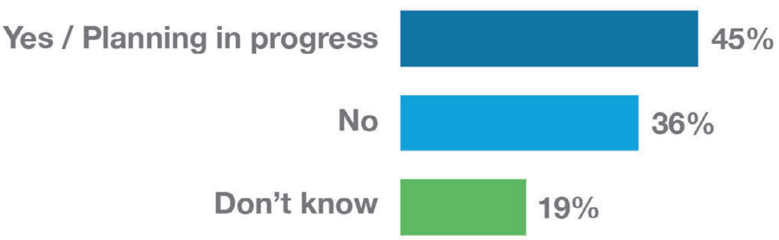
[20] Xinhua, China, forex regulator approves new QFII, RQFII quotas, 6 May 2019, http://www.xinhuanet.com/english/2019-05/06/c_138038324.htm

Despite the existing problems, the PFM WFOE is set to be a key focus for investors with 45 per cent of respondents either having or planning a WFOE versus 36 per cent who have no plans. Of those setting up a WFOE, 74 per cent intend to apply for a PFM licence, followed by Qualified Domestic Limited Partnership/ Qualified Domestic Investment Enterprise (53 per cent), public fund (47 per cent) and Qualified Foreign Limited Partner (26 per cent).

Access channels continue to be a core driver of investment flows with the liberalisations of the past 12 months making it easier and simpler to buy onshore assets. The final major challenge for regulators is to give investors the tools and flexibility to proficiently manage their FX risk.

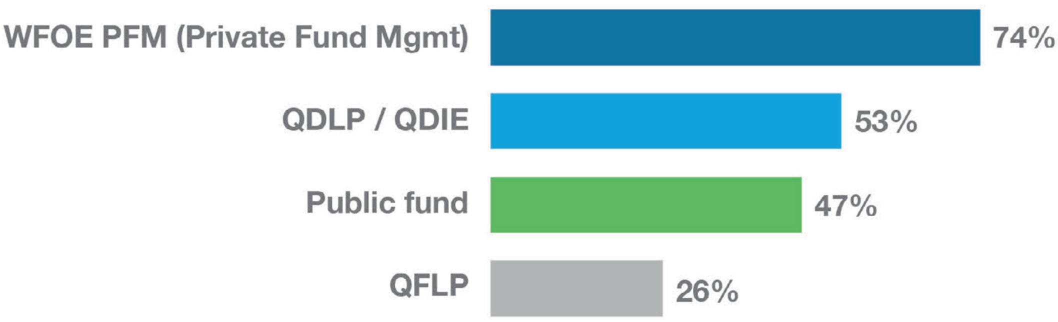
2.7 Intended plans for WFOE

Do you have plans to have a wholly foreign-owned enterprise (WFOE) in mainland China?



Intended purpose for WFOE

What is your intended purpose for setting up a (WFOE) in China?



Weighing up the benefits of index inclusion

Twelve months on from the first entry of China assets into a major investment benchmark and index inclusion is proving to be the ultimate catalyst for improving China access, driving both regulatory reform and investor interest. At the time of last year's whitepaper, investors were still assessing the impact of MSCI including A-shares into its Emerging Markets Index which had recently taken place. At the same time, markets were weighing up the possibility of bond inclusion following Bloomberg publishing the criteria in March 2018.

Unsurprisingly, the inclusion of Chinese bonds has been one of this year's decisive events – an event correctly predicted by 53 per cent of respondents to the 2018 survey. Starting in April, the Bloomberg Barclays Global Aggregate Index began including onshore bonds, with plans to phase them in over a 20-month period to account for around 6 per cent of total AUM.[21]

The catalytic effect has been clear. Within five months of Bloomberg publishing the criteria for inclusion – DVP, block trades and tax clarification – China's regulators announced measures that met all three. And as highlighted in the previous section, demand for Bond Connect licences has soared over the past year. And at the time of writing, investors were preparing for a second equity inclusion with FTSE Russell due to start including Chinese A-shares into the FTSE Emerging Index, reaching a weighting of around 5.5 per cent by March 2020.[22]

Investors struggle to be ready for index inclusion

However, what has become clear from both the MSCI and Bloomberg inclusions is that investor interest does not always relate to investor activity. Standard Chartered understands that a number of asset managers have asked Bloomberg for temporary waivers allowing them to deviate from the index as they are not yet ready to include Chinese bonds into their strategies. And while there are now more than 900 accounts on Bond Connect, so far only around one-third have made an investment. However, this should be attributed to a lack of market readiness rather than a lack of demand, said a roundtable participant.

"The majority of accounts are still sorting out their internal procedures: setting up their straight-through processing, switching trading platforms or negotiating how to do CNY FX with custodian banks. So probably by the end of this year we will have a clearer picture of the trading activities," he said.

This idea is certainly supported by the survey findings highlighted in the previous chapter that access to FX and account opening remain major challenges for investors. A similar phenomenon was evident during the first phase of MSCI A-shares inclusion in June 2018. Initially A-shares took up a weighting of 2.5 per cent, accounting for 0.8 per cent of the index. However, as this was less than the deviation allowed under the index rules, if they so chose, asset managers did not need to fully match the A-shares allocation. With MSCI now increasing the weighting to a size that cannot be ignored without seeking a waiver, markets will be tracking how this impacts flows into China.

However, Standard Chartered research suggests index inclusion is having a positive impact on flows. Official data shows that foreign inflows to China onshore bonds and equities stood at USD36 billion in Q1 2019, up from USD8 billion in Q4 2018. Moreover, we expect foreign inflows to increase to an average USD60-70 billion in the third and fourth quarters supported by index inclusion, up from an estimated USD30 billion in the first half of 2019.[23]

That said, the survey results do indicate there is some investor reticence around index inclusion. Only 11 per cent of respondents said historical index inclusion was an influencing factor for starting or increasing China

[21] Bloomberg, Bloomberg confirms China inclusion in the Bloomberg Barclays Global Aggregate indices, 31 January 2019, https://www.bloomberg.com/company/announcements/bloomberg-confirms-china-inclusion-bloomberg-barclays-global-aggregate-indices/

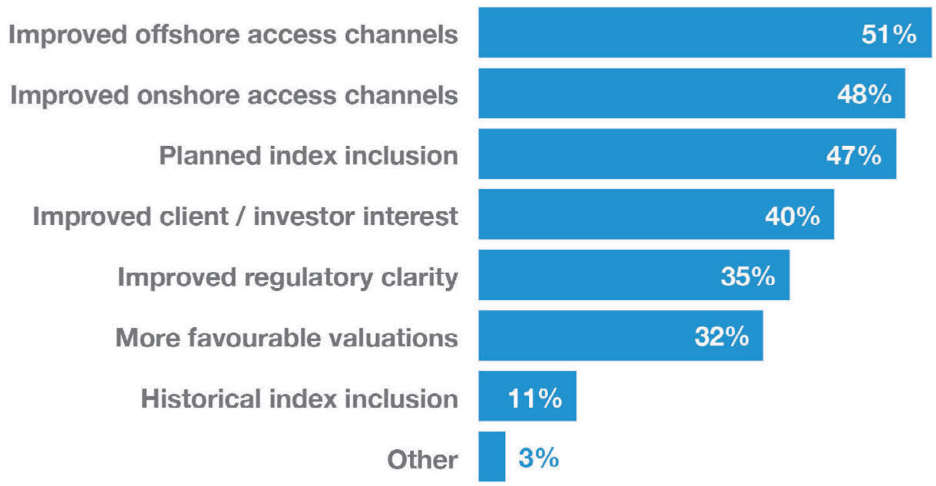
[22] FTSE Russell, FTSE Russell promotes China A shares to emerging market status, 26 September 2018, https://www.ftserussell.com/files/press-releases/ftse-russell-promotes-china-shares-emerging-market-status

[23] Standard Chartered, Global Research, Doengrading CNY outlook amid a new equilibrium, 9 July 2019

3.1 Major announcements on China market access - June 2018 to July 2019

Date	Development	Access channel
August 2018	Delivery versus payment fully implemented on Bond Connect	Bond Connect
	Standing Committee of the State Council announces three-year tax exemption on bond interest for foreign investors	
	Block trade allocations permitted on Bond Connect	
September 2018	Introduction of investor ID regime for northbound investors on Stock Connect	Stock Connect
	FTSE Russell announces it has promoted China A-shares to Emerging Market status; phased inclusion into indices to begin June 2019	Index inclusion
October 2018	China Securities Regulatory Commission publishes initial guidelines for Shanghai-London Stock Connect	Stock Connect
	Standard Chartered becomes the first foreign bank to be granted a domestic fund custody licence by the China Securities Regulatory Commission	WFOE
November 2018	Shanghai Stock Exchange publishes preliminary rules for Shanghai-London Stock Connect	Stock Connect
	Bloomberg becomes the second approved trading platform on Bond Connect	Bond Connect
December 2018	Securities and Futures Commission postpones the launch of ETF Connect; focuses on cross-listings	ETF Connect
	Securities and Futures Commission announces plan to introduce investor ID regime for southbound trading on Stock Connect	Stock Connect
January 2019	China launches consultation on merging QFII and RQFII and broadening the list of eligible investments	QFII/RQFII
February 2019	MSCI announces it will increase the weight of China A-shares from 5% to 20% in three steps starting May 2019	Index inclusion
March 2019	Central Bank of Ireland approves UCITS and AIFs to invest via Bond Connect	Bond Connect
April 2019	Bloomberg Barclays Global Aggregate Bond Index begins including Chinese onshore bonds	Index inclusion
	FTSE Russell announces China bonds are under review for entry into the World Government Bond Index; next decision is September 2019	
	Japan Exchange Group and Shanghai Stock Exchange announce plans to launch Japan-China ETF Connect	ETF Connect
May 2019	Proposal to allow foreign investors to switch fixed income assets between access channels	CIBM Direct, QFII/RQFII
June 2019	Shanghai-London Stock Connect launches	Stock Connect
July 2019	Southbound Stock Connect investors will be able to invest in dual-class shares	Bond Connect

3.2 Factors influencing the decision to start or increase investment to China



investment. More positively, 47 per cent said planned index inclusion would be a reason to start or grow China investment.

Caution hurts investment flows

That said, if investors have largely held back from fully adopting the weightings under index inclusion, it raises questions for the likelihood of future index inclusions and more importantly, the opening of China's markets to foreign asset managers.

The next major test will come in September 2019 when FTSE Russell will announce whether it will include Chinese onshore bonds in the FTSE World Government Bond Index (WGBI). While FTSE Russell has not set specific inclusion criteria for Chinese bonds, the index provider does set Market Accessibility Levels for all fixed income securities, which are split into four main areas: market, macro-economic and regulatory environment; foreign exchange market structure; bond market structure; and global settlement and custody.[24]

There is already some indication that investors remain cautious. Anecdotal evidence suggests that Japanese investors may vote against inclusion. This is because many struggled to be ready for Bloomberg's index inclusion due to the volume of due diligence required to be allowed to invest in onshore Chinese debt.

If FTSE Russell decides not to go ahead with bond inclusion, it will show that there are issues around market readiness and acceptance that are still to be resolved despite the previous rounds of index inclusion. The same is true if the index provider decides to move forward with inclusion, but it does not lead to the expected inflows. Given that inclusion has taken place for two equity indices and one bond index, a poor outcome next time around will be much harder to ignore and may put pressure on China's regulators who have promoted and pushed market access acceleration on the basis that it will lead to a significant increase in money heading into China. The disparate nature of China's financial regulatory regime means significant effort is required to coordinate the work of different institutions towards making the changes needed for index inclusion – such as the clarification on tax. If the inflows fail to match the expectations, this could hamper the willingness of China's regulators to act to further liberalise markets as well as slow down future index inclusion.

[24] FTSE Russell, FTSE fixed income country classification process, January 2019, https://www.ftse.com/products/downloads/FTSE_Fixed_Income_Country_Classification_Process.pdf

Full index inclusion still expected

Certainly, respondents to this year's RMB Investors Forum survey still believe that full index inclusion for Chinese assets is some time away. Thirty-nine per cent of respondents felt that it will be two years before China is included in all major indices with the appropriate weighting. Next was 12 months with 31 per cent followed by three years with 21 per cent, while nine per cent put the timeline at four years or more.

It is worth noting that by job function, operations are the most optimistic with 39 per cent expecting full index inclusion after 12 months. This perhaps reflects thinking that the size of the inclusion does not matter once the back-office processes are in place. At the same time, operations are also among the most bearish with 29 per cent polling that it will take three years or longer, while this proportion is 30 per cent among regulators.

Index inclusion continues to play a vital role in accelerating regulatory reforms and raising investor interest in China investment. However, without the corresponding pick-up in investment flows, there is a risk that the recent momentum in market liberalisation slows down.

Conclusion

The RMB Investors Forum 2019 survey proves that China is now a priority for investors around the globe. Never has it been easier to access China's markets and this is leading to a growing sophistication in products and strategies as well as a broadening of the investor base beyond institutional mandates.

While there has been some moderation in investor sentiment, this can be mainly attributed to the rising trade tensions between the United States and China. Yet while rivalry between the world's two largest economies is likely to continue for some time, investors believe any impact on flows into China is likely to be short term and not damage the rationale for investing in mainland assets.

Moreover, as long-term China investors start to reach their exposure limits, new markets are stepping into their place to drive future momentum, this year's survey shows.

"The interest in China is still growing and we see a lot of new business throughout the globe. Whether it's Asia, Europe and the United States, we see that there is interest from all investors in China," said Joost Lobler, Head of Sales, Investors, Transaction Banking, Securities Services, at Standard Chartered.

Thanks to the success of MSCI inclusion and the removal of regulatory barriers, Stock Connect and Bond Connect have gone from strength to strength. In addition, proposed changes to the QFII and RQFII programmes are poised to herald a revival in these schemes as investors seek to gain access to the broadest range of onshore assets and support efforts to set up an onshore fund management business through the WFOE scheme.

The ease of access afforded by these channels combined with plans for further liberalisation has helped to ameliorate many of the key investor concerns around issues that have previously dominated discussion, such as regulatory uncertainty and account opening.

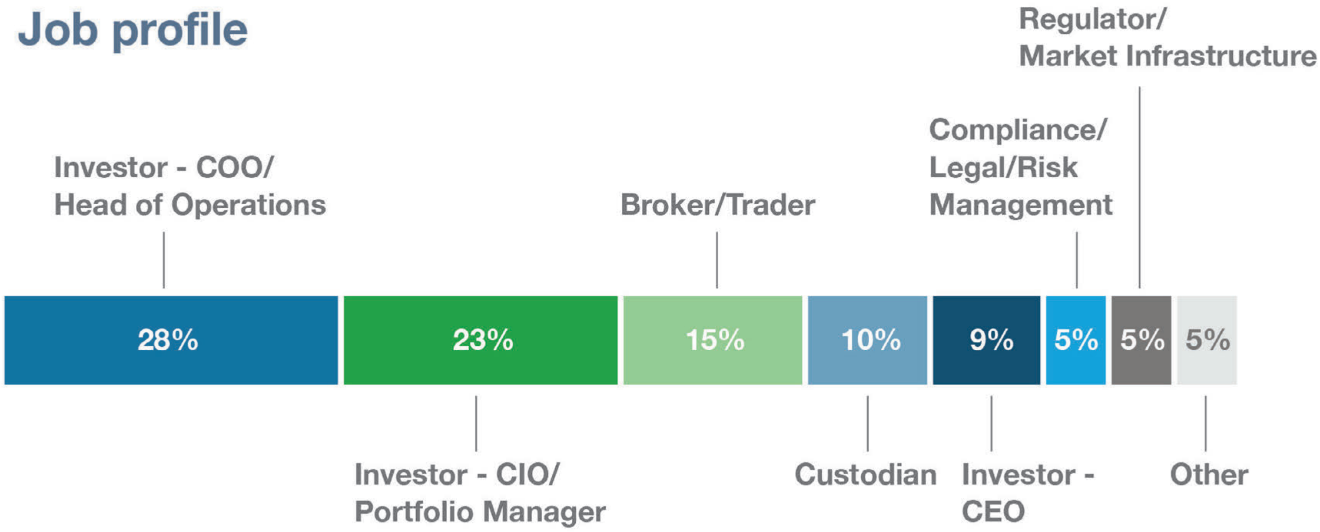
However, this has also brought into sharp focus the lack of a comprehensive solution to managing FX risk across all the channels, which continues to be a large barrier to entry. It remains to be seen what further action China's regulators will take in this area.

Once again, index inclusion has proved to be a vital mechanism to open up China's markets with the addition of onshore bonds leading to a raft of changes on Bond Connect. However, index inclusion risks being a pyrrhic victory if it is not accompanied by a noticeable pick-up in investment flows. Whether it is driven by caution or the challenge of meeting due diligence requirements, investors will need to overcome these issues to show regulators they are responding positively to index inclusion or risk a slowdown in the momentum to reform.

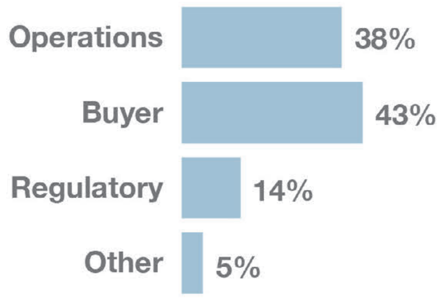
Methodology

The RMB Investors Forum survey was conducted in March 2019 as an online survey sponsored by Standard Chartered. The survey reveals how investors view the China market, their investment plans, China investment strategy and channel usage. It also highlights the drivers behind their plans to invest in the China market. More than 130 market participants responded, in roles that span both front and back office. Respondents are segmented by function (buyers, operations, regulators), by geography (Hong Kong, Taiwan, China, other Asian countries as well as United States and United Kingdom/ Europe), and by their investment strategy.

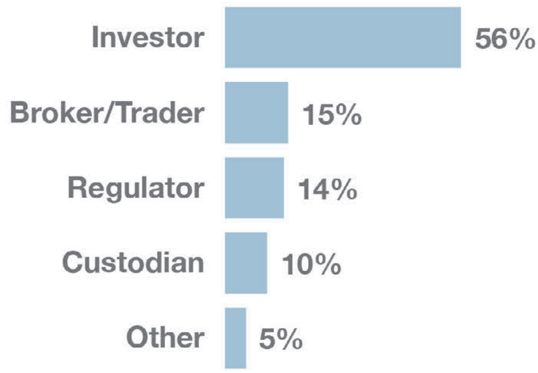
Job profile



Role type*



Company type*



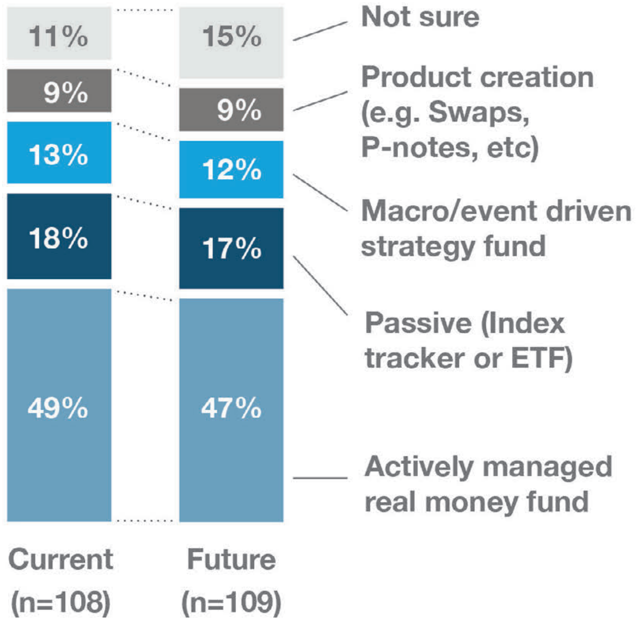
* Operations = Investor COO/Head of Operations + Custodian; Buyers = Investor CEO + Investor CIO/Portfolio Manager + Broker/Trader; Regulatory = Compliance/Legal/Risk management + Regulator/Market infrastructure; Investor = Investor COO/Head of Operations + Investor CEO + Investor CIO/Portfolio Manager

Market

Hong Kong	47%	62
Taiwan	11%	15
Europe	11%	15
China	10%	13
Korea & Japan	6%	8
Singapore	6%	8
North America	6%	8
Thailand	2%	2
TOTAL	99%†	131

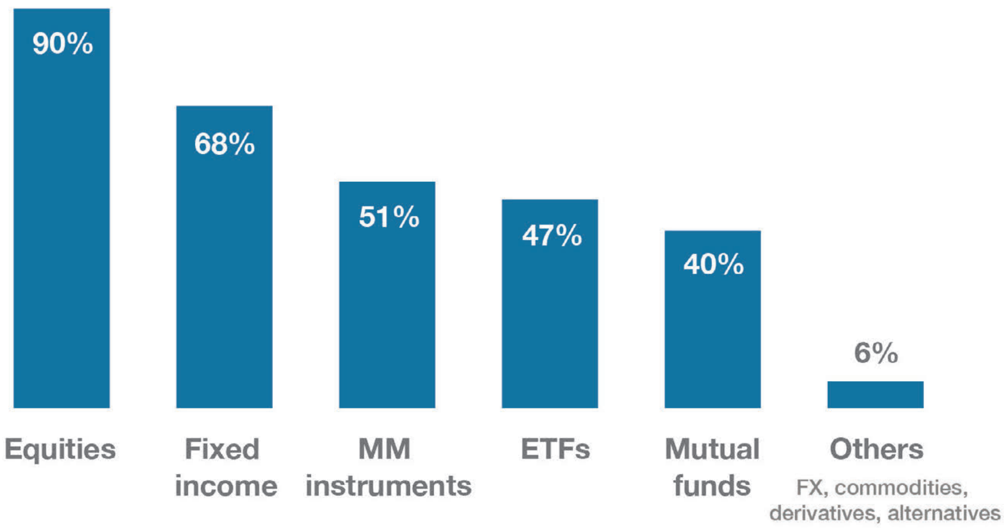
† Doesn't add up to 100% due to rounding

Investment Strategy



Excludes current investors who are not sure of the future

Asset Classes



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