



Growing Asia's Markets



China's Capital Markets

Navigating the Road Ahead

March 2017



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A. Executive Summary

China's capital markets have developed at a pace that has few parallels in history. In some sectors of the financial industry, such as digital payments, China today sets an example for the rest of the world. Other recent examples of impressive progress are the dramatic opening of the Chinese Interbank Bond Market (CIBM) to a wide range of international investors under accommodative conditions in early 2016; the introduction of registration systems for the Qualified Foreign Institutional Investor (QFII) and RMB QFII (RQFII) programmes, replacing the slow and less transparent quota application system; the Stock Connect scheme, unique in design yet operating smoothly for over two years; the upgrading of the China Foreign Exchange Trading System (CFETS) foreign exchange platform, which could bring FX trading in China on a par that of developed markets. Such examples hint at the potential for China's financial markets to transform themselves and adapt to the requirements of a growing economy and an ever-more sophisticated populace.

Consistent with ASIFMA's mission, however, our aim in this paper is not to enumerate past successes but to identify those issues, policies, or capital market structures that could be tweaked, modified, or reformed in ways that we believe will be essential to sustaining the continued vigorous economic growth on which future prosperity depends. We draw on the collective experience and expertise of our membership to suggest how we believe China's capital markets can adapt to accommodate the needs of an economy increasingly driven by global competition, innovation, and the needs of consumers. ASIFMA's affiliates in the US and Europe similarly engage in vigorous and productive interaction with government agencies and market participants with the aim of achieving improvements. We believe that with the right reforms China has an opportunity to learn from the experience of developed markets, avoid their mistakes, and leapfrog their successes.

While we have set out specific recommendations at the end of each chapter, we do not list them in any order of importance or prescribe a sequence for their implementation. The reality is that governing a country the size of China is extremely complex and the key message is to do what is achievable rather than adhere rigidly to particular order of action. Over-emphasis on the order of implementation could risk bogging down reforms in regulatory inertia or disagreement on nonessentials. Moreover, most capital market reforms are highly inter-connected. A policy goal such as increased fixed income secondary market liquidity cannot be achieved without implementation of a whole cluster of smaller reforms such as close-out netting, establishment of a classic repo market, participation of banks in bond futures markets, etc. We believe that the vast majority of reforms recommended in this paper need to occur if China's capital and financial markets are to reach their full potential.

For reform to work, technical cooperation across multiple agencies is required. Taskforces should be formed to address particular problems by analysing them in a holistic and interconnected manner. Seeking wide industry input during the analytical stage would be helpful to ensure understanding of operational and implementation aspects.

China has long relied on a successful approach of utilising limited experiments and pilot programmes as test cases for reform, and only after assessing the record of such pilots expanding them to bring about broader and deeper opening. Whether such a cautious approach will continue to work is now



debatable. While we are not calling for a “big bang” approach, an accelerated reform programme for capital market development is now likely needed. On one hand, the likely end to a low-interest rate environment globally may well see global capital (including Chinese capital) seek higher yields in the US, and likely other developed economies as yields rise, leading to a more capital-constrained environment for developing markets including China. On the other hand, the greater complexity of China’s economy and sophistication of its market participants calls for a financial infrastructure which is both flexible and robust.

A broader reform agenda that encourages the development of a deeper, more liquid capital market with greater choice of investment products is the best counter-weight to the exchange rate driven concerns that are resulting in greater outflows of capital. While Renminbi (RMB) internationalisation appears to have reversed at least temporarily, the choice between financial stability and the freedom and flexibility of a global currency demanded by international investors will increasingly become a challenge if capital markets are to be developed to ease the transition to a consumption-led economy. There is no single easy answer to this tension, but rather a constellation of inter-related actions leading to the larger goal. We believe the ASIFMA recommendations in this paper chart the path. The full list of recommendations can be found at the end of each section.

1. China’s Capital Market in General

In order to achieve the best reform possible, the application of a systematic cost-benefit analysis to proposed new regulations (including their cumulative impact) would be highly beneficial to ensure that such regulations are targeted and that benefits will exceed costs. Additionally, increased regulatory transparency and consistency through a more open consultation process is called for with the participation of key market participants (including foreign participants via English language documents) in order for capital market reforms to be successful.

Feedback from investors is a key to the development of financial markets. Maintaining a close dialogue with institutional investors to promote a market environment attractive to their participation is paramount and should be done at the early stage of development so that problems can be identified quickly and then addressed with potential solutions. Promoting retail investor education that clearly conveys the importance of risk management and diversification is also a requirement of continued and stable financial market development.

Providing ample notification of new rules as well as allowing sufficient time for public comment and implementation will significantly improve the regulatory rule making process.

China has been a world leader in the adoption of technology-led solutions. China should build on this enviable record of exploiting technology to make China’s financial markets the best in the world for investors by offering innovative, high-quality services at low cost. An aspect of this strategy should be to allow the use of alternative trading systems and venues across all financial products thereby driving down the costs raising the quality of services, and fostering market liquidity and efficiency.



2. Equities

While relatively advanced in development compared to other asset classes, the continued evolution of China's equity market is critical to further reform of its financial markets. Adopting global standards on such matters as trading suspensions, stock borrowing and lending, short selling, delisting of substandard companies and trading suspensions, and settlement of securities is critical if China desires to diversify its equity market and attract greater foreign investment into equities.

3. Fixed Income

Fixed income embraces a highly diverse range of products and markets ranging from plain vanilla risk free assets like government bonds to more complex but socially useful ones like asset backed securities (ABS). As such, one size does not fit all and reforms need to be carefully considered in light of the requirements of each product or market.

One of the key reforms that would impact not just fixed income products but all asset classes is the continued development of a liquid secondary bond market, transitioning away from the current situation where the majority of bond issues are held to maturity on banks' balance sheets. This requires the adoption of a trading and credit culture among a diversity of investors including both domestic and foreign ones that includes central banks, asset managers, pension funds, insurance companies, as well as hedge funds.

Crucially, secondary liquidity can only be achieved with the creation of a "classic" repo market to develop a "two way" bond market, as repo facilitates investors going both "short" and "long" debt securities. It also requires the development of derivatives and other hedging instruments, both over-the-counter (OTC) and listed (including credit derivatives or Credit Default Swaps (CDS)), and opening them to a wider range of participants. Either of these reforms can only be achieved if close-out netting is recognised in statute.

4. Foreign Exchange

The upgrade of the CFETS platform with the NEX Markets platform should bring electronic execution in line with that of developed markets. However, there are further opportunities to improve efficiency and drive down costs of execution as well as addressing the settlement risk, which will deliver higher levels of prudent risk management and enhance financial stability.

Given that FX options have been a permitted instrument for a number of years, there is also an opportunity to introduce new products to provide end users with a wider opportunity to hedge their currency exposures at a lower cost.

The developed-country FX markets have evolved, in part, due to lessons learned from experiences of major market events (such as the Bank Herstatt bankruptcy) and as a result have become more efficient. China has the opportunity to leverage these lessons and market practices to improve the efficiencies in its domestic market and to enhance access and risk mitigation for investors.



The introduction of a financial transaction tax (FTT) at this stage risks harming market liquidity, increasing transaction costs and other positive market reforms as well as triggering greater capital outflow.

5. Laws and Regulations

The markets would benefit from greater transparency and consistency in policy and regulation setting through a more open market consultation process allowing for public comments and sufficient notification of new rules and implementation lead time. This would improve the levels of international investor confidence by reducing the levels of regulatory risk.

There is a need to implement a resolution and recovery regime for financial institutions consistent with the Financial Stability Board's Attributes of Effective Resolution Regimes for Financial Institutions in order to provide clarity about an investor's place in the credit structure of Chinese banks.

6. Market Infrastructure

In order to minimise the risks for entities clearing on the Shanghai Clearing House (SHCH) there is a need to incorporate the enforceability of close-out netting in statute, support the exchange of margin through amendments to the Securities Law and allow for third party custodians to hold initial margin on behalf of the posting counterparty.

The authorities, in conjunction with the SHCH, should prioritise the application of the SHCH to be recognised as an equivalent clearing house under European legislation and as a Derivatives Clearing Organisation (DCO) under Dodd Frank in the US.

We believe facilitating access to China's capital markets by permitting international investors to use omnibus accounts would be welcomed by international players as it would allow them to benefit from cost savings and efficiencies through simplification of operating models.

Whilst China's priority is to develop its own market infrastructure, it is important to ensure that it is compatible with international standards if China is to expand the use of the RMB as an international currency. This would include ensuring compatibility with CPMI-IOSCO's Principles for Financial Market Infrastructures (PFMI) and the settlement of RMB on a payment-versus-payment (PvP) as highlighted in the BCBS's regulatory guidance on mitigation of settlement risk.

7. Market Access

Streamlined and simplified market access programmes would lower the costs and risks of investing in China and enhance the attractiveness of Chinese investment products to international asset managers. Among the most effective reforms would be to remove the foreign ownership cap for securities, trusts, asset management and other entities, to enable international institutions to acquire underwriting and settlement licenses on a fair and transparent basis, to expand the scope of permissible securities for access programmes and remove repatriation limits, to amend stock connect rules to enable affiliates of Exchange Participants to borrow and lend stock, to clarify the CIBM rules on quota limitations, to increase the scope of firms allowed to issue panda bonds, to



improve panda bond accounting rules and allow international credit rating agencies to rate them, and to adopt a flexible interpretation of the Cybersecurity Law. A more robust credit system would strengthen and attract more investors, in particular, to the fixed income markets. Finally, we note that while the steady expansion of the various access programmes has been welcome at every step, cumulatively the programmes have become complex. Hence, we would suggest that simplification of the programmes along with clarity and consistency among them wherever possible would be another valuable step toward making China's markets more accessible.



B. Introduction

China's rapid economic growth has led to significant wealth generation, but key challenges will likely need to be addressed for stable growth to continue on a sustainable path. In the past, China's financial model was based to a large degree on state-owned banks lending to state-owned enterprises (SOEs), which in turn exported products to developed markets or financed domestic infrastructure projects. This cycle was ultimately funded by China's large base of domestic deposits, which are the result of high savings rates, lack of alternative investment options, and the relative security of bank deposits. While this financial model is undoubtedly successful in an export-driven economy in the early stages of development, expected changes in demand from Western economies, an aging demographic, increasing labour costs, and new infrastructure needs will require a more balanced and stable growth model fuelled by consumption and increased spending.

Managing this transition well and without any major disruption will be the key challenge for policy makers over the medium term and it remains an open question whether China can avoid becoming stuck in the "middle income trap" as several other developing countries have before it. Increasingly, China is struggling to find the balance between supporting the economy with loose credit conditions as it transitions to a consumption-based economy and preventing a destabilising build-up of debt that could bring a shock to the economy down the road.

China's financial markets have already benefited from increased openness and a range of reform efforts over the last two decades, supported by global and regional organisations such as the World Trade Organisation, International Monetary Fund (IMF), Asia-Pacific Economic Cooperation (APEC) and Asian Development Bank (ADB). In addition, China's online finance industry has developed robustly in the past few years, with many key indicators leading the world, such as the number of online shoppers and the extended market size. Nevertheless, while the pace of economic growth in China continues to exceed that of most developed and developing economies, the structural development of its capital markets has not kept pace. It is our view that this must change if high growth levels are to be maintained. Government policies should continue to encourage the development of capital markets in ways that will support China's various economic and social development initiatives including advancing its transition from an export-driven economy to a consumption-driven economy, reducing the concentration of risk in the banking system, funding infrastructure projects through the capital markets, developing social safety nets and powering its urbanisation programme.

In the next decade, programmes to address the needs of China's aging population will likely stretch government finances, making less public money available for infrastructure, education, urbanisation, and other needs. Expanded capital markets could help cope with rising pressure to extend social-safety nets, while at the same time providing enough long-term capital to fund China's urbanisation and social development efforts. Moreover, the country's high savings rate, even if reduced by greater spending in a more consumption-driven economy, can be productively funnelled into the capital markets through private pension and insurance, thus reducing the population's reliance on government programmes and domestic banking institutions.



Additionally, long-term foreign investment is more readily attracted to countries with well-regulated, diverse markets than those heavily reliant on bank lending. Chinese banks traditionally lend short-term, limiting the duration of debt available in the economy. Debt issuance is not seen as a viable funding mechanism for longer-term infrastructure development. China's relatively underdeveloped capital markets require domestic banks to make longer-term loans to municipalities, saddling them with underperforming assets and concentrating credit risk in the banking sector. The resulting maturity mismatch is inherently risky. Fortunately, this model is starting to change with the advent of a municipal bond market.

The development of robust capital markets through more accommodative government policies will also help increase market transparency. The rash of market manipulation accusations and fraud scandals afflicting Chinese markets has put increased pressure on the government and regulatory authorities to address the problem head on. Extensive financial reporting and proper risk assessment are fundamental to well-functioning capital markets. This will also support better corporate governance and instil greater trust in the marketplace, to the benefit of all market participants and stakeholders.

The substantial infrastructure still needed to spread development geographically, extend social safety nets, improve productivity and sustain high economic growth requires the efficient mobilisation of private and public capital. To ensure continued and sustainable growth, China should continue to pursue government policies that allow for capital market development and that broaden the array of financing and investment possibilities to complement, and ultimately transform, the over reliance on bank-lending and pave a transition to a consumption-based economy.

It is true that China's financial markets have already benefited from increased openness and a range of reform efforts over the last two decades. It is our view that this trend must continue if China is to manage the transition to a consumption-based economy while minimizing risks of economic shocks.

In light of the foregoing, this paper will review the macroeconomic backdrop for China, and the three major asset classes of its markets: Equities, Fixed Income, and Foreign Exchange. In addition, it will look at Laws and Regulations, Market Infrastructure, and Market Access. It will also include specific recommendations for Chinese policy makers and regulators on how to further develop their capital markets will be listed at the end of each section.

C. Macroeconomic Backdrop

China's growth rate will likely remain high by global standards. The services sector in particular will likely experience a continued boom, supported by urbanisation, government policies and technological progress. On the other hand, the outlook is less optimistic for fixed asset investment and manufacturing growth over the longer run. Construction may remain strong due to massive outlays on public transportation and communication networks, while manufacturing is likely to provide decent growth to satisfy demand stemming from continued industrialisation, infrastructure spending and consumption. These forces will be somewhat offset by a weakening foreign demand for export-driven products and greater competition from other countries in the region. Financial services are another sector, led by internet finance, which may help drive expansion, though this source of growth may be at risk if the prevalence of non-performing loans (NPLs) in the traditional banking sector increase.

Gross Domestic Product Annualised Percentage Growth Rate (2012–2016)

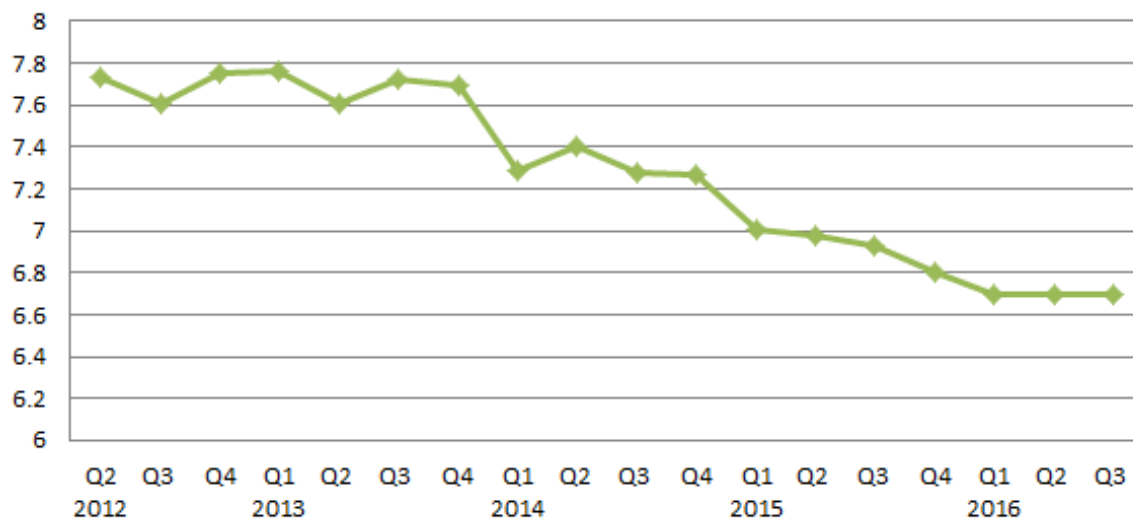


Figure 1: Gross Domestic Product Percentage Growth from Q2 2012 to Q3 2016 (Last seen Jan 2017)
 Source: National Bureau of Statistics China

Notwithstanding the considerable potential for sustained growth, the economy has slowed and growth has not been accompanied by more debt implying increasing risk.

In coming years, China's economic growth trend will be "L-shaped" rather than "V-shaped."¹ The debt-to-GDP ratio has expanded from 150 percent to more than 232 percent in a decade.² China's total debt to GDP ratio suggests elevated risk compared to other developing economies in Asia.

¹ "China's economy likely to follow 'L-shaped' path in coming years, says an 'authoritative insider'" The People's Daily, May 9, 2016. <http://en.people.cn/n3/2016/0509/c98649-9055137.html>.

² Browne, Andrew. "Chinese Debt Soars Into Space." The Wall Street Journal, September 13, 2016. <https://www.google.com.hk/webhp?sourceid=chrome-instant&ion=1&espv=2&ie=UTF-8#q=the%20wallstreet%20journal>.



Asian Debt Comparison (Percent of GDP)

Indicator	China	India	Indonesia	Korea	Malaysia	Philippines	Taiwan	Hong Kong	Singapore	Australia	Japan
Economy (overall)	232	138	66	228	193	88	137	293	259	239	409
Private Corporate Sector	126	56	23	105	50	44	57	226	84	81	101
Household Sector	40	13	17	56	87	7	42	67	75	123	65
Government Sector	66	69	26	37	58	36	37	0	100	35	244
External Debt/GDP	16	24	37	31	70	26	33	447	447	113	67
FCY of Total Debt	63	75	85	71	47	97	N/A	63	0	28	35

Figure 2: Comparison of Asian countries' debt as of Apr 2016
Source: Bloomberg, BIS, IMF, World Bank, Standard Chartered Research

Compared to other developing countries, China's private corporate sector debt level is high. However, unlike its peers very little of China's debt is owed externally and of that portion, a modest amount is owed in foreign currency. This gives China more flexibility and less exposure to external shocks.



D. Equities

The continued development of China's equity market is critical because a well-functioning equity market lowers the cost of capital, supporting the most vibrant portions of the Chinese economy. Improvements in productivity — the bedrock of improvements in living standards — almost always come from innovative, young companies, and equity markets serve to channel capital to them. Equity capital is also important for established companies, especially more successful ones, to grow and innovate. Unlike bank loans or bonds, equity is not repaid, encouraging healthy risk taking because the certainty of financing gives managers confidence to design and execute long-term plans. It makes possible long-term investment in research and development, human capital and plant and equipment that produces gains in jobs, higher consumption, and a larger tax base. Because it is an alternative to debt, equity also reduces leverage and hence systemic risk.³

A dynamic equity market is essential to achieve the ambitious economic reform plans of the 2013 Third Plenum to “reach a new stage of development.” Moreover, if Shanghai is to become one of the world's global financial centres by 2020, a goal announced by the State Council in 2009, China's stock markets will have to meet global standards.

Since the establishment of the Shanghai (SSE) and Shenzhen (SZSE) stock exchanges in 1991, the Chinese equity market has sped past various milestones. As of December 2016 China has the world's second largest stock market, even excluding Hong Kong, with a combined aggregate market capitalisation of USD 7.3 trillion.⁴ In 2016, Chinese companies raised USD 20 billion of equity capital, more than the combined amount raised in the US and Europe over the same period.⁵

Market Capitalisation of Stock Exchanges for Top Five Countries

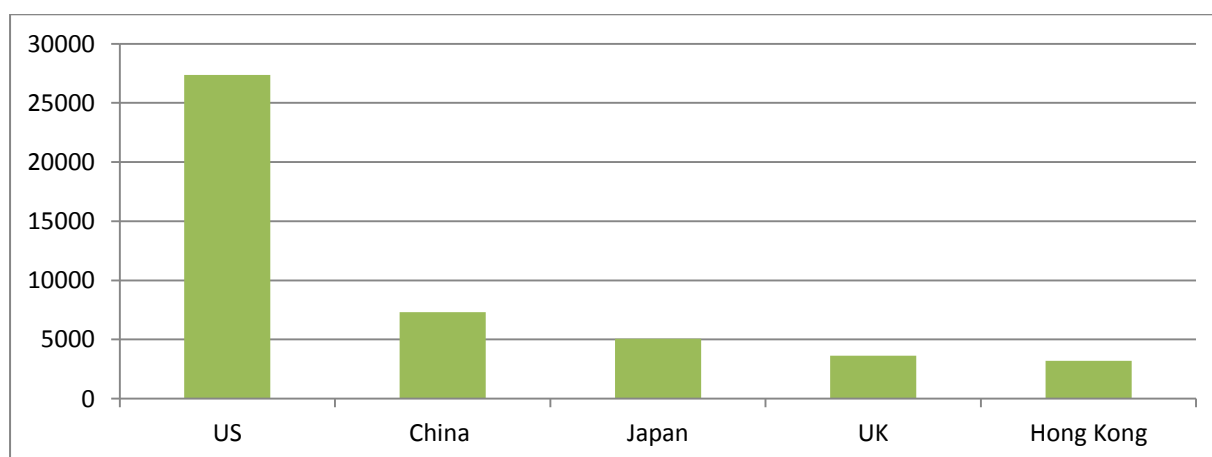


Figure 3: market capitalisation is in USD billion as of Dec 2016.
Source: Securities & Futures Commission of Hong Kong

³Krohn, Christian. "Why equity markets matter," AFME December 2015.

http://www.afme.eu/globalassets/downloads/publications/afme_whyequity_nov2015_low-res.pdf.

⁴"Market Capitalisation of the World's Top Stock Exchanges." Securities and Futures Commission. December 2016.

<http://www.sfc.hk/web/EN/files/SOM/MarketStatistics/a01.pdf>.

⁵Yiu, Enoch. "Hong Kong tops global IPO markets despite total funds raised sliding to eight-year low." South China Morning Post, December 27, 2016. <http://www.scmp.com/business/companies/article/2057428/hong-kong-tops-global-ipo-markets-despite-total-funds-raised>.



A healthy equity market would channel capital to China's most dynamic sectors. According to China's National Bureau of Statistics, small and medium-sized enterprises (SMEs) account for over 97 percent of registered industrial firms in China. SMEs employ nearly 75 percent of the country's workforce and generate 65 percent of GDP.⁶ But SMEs have a harder time getting capital than slower-growing state-owned enterprises. At present, SOEs get over 75 percent of loans that are extended by state-owned commercial banks. As a result, SMEs often turn to non-bank financing from shadow banks, which is more expensive.⁷

China's private companies have historically displayed higher factor productivity growth compared with SOEs. A study from the World Bank found that private firms enjoyed significantly higher returns on equity between 1998 and 2009. In 2009, private firms' return on equity was 20 percent, compared with 10.1 percent for SOEs. From 2010 through 2014, private firms raised RMB 660 billion through initial public offerings through the Shanghai and Shenzhen stock exchanges; SOEs raised RMB 166 billion in the same period.⁸ While this may look like private firms are more successful at issuing equity capital, many of the SOEs had already raised equity capital prior to 2010 and were consequently collectively less in need.

Return on Assets of State and Private Industrial Firms (1996-2014)



Figure 4: total profits earnings before corporate income tax in RMB billions from 1996 to 2014
Source: National Bureau of Statistics of China

⁶ "中小微企业对GDP的贡献超过65%." EastDay, May 3, 2015.

http://news.eastday.com/eastday/13news/auto/news/china/u7ai3544562_K4.html

⁷ Tsai, Kellee. "Financing Small and Medium Enterprises in China: Recent Trends and Prospects beyond Shadow Banking." HKUST Institute for Emerging Market Studies, May 2015.

⁸ Lardy, Nicholas R. Markets over Mao: the rise of private business in China. Washington, DC: Peterson Institute for International Economics, 2014.



1. Market structure

1a. Electronic trading

Market participants worldwide have benefited enormously from technical innovation in equity markets and the consequent evolution of market structure in recent years. Transactions costs have been dramatically reduced, which translates directly into a lower cost of capital and better investment outcomes. Automation has enabled venues to handle much higher volumes, and intermediaries to customise trades to meet the portfolio objectives of clients in ways that would previously have been technically impossible or prohibitively expensive. As China's stock markets mature, it is important that they continue to invest in technology to provide innovative services to market participants. A 2016 study by the World Federation of Exchanges found that advances in trading technology will attract investors and foster healthy liquidity.⁹ China's markets are technologically advanced but somewhat disconnected from the rest of the world because of differences in operational structures and systems.

Electronic trading has dramatically improved trading efficiency enhancing connectivity between clients and brokers via third party vendors and by making possible the use of trading algorithms. Connectivity between clients' and brokers' order management systems is an essential way to reduce communication and operational errors. Such a feature is key to clients who are trading baskets (or rebalancing index-based portfolios). In international markets, those connections are commonly done via third party vendors using the Financial Information Exchange Protocol (commonly known as "FIX" connectivity).

Algorithmic trading is essential to many execution strategies in modern markets, and agency algorithms that reflect accepted practice and help clients to achieve best executions (such as VWAP, TWAP etc.) should be promoted to sustain healthy market evolution.

The risk of making regulatory changes whose impacts on such technologies are uncertain could damage the proven benefits of modern market structures and possibly introduce risks that did not previously exist. Such an outcome would be a loss for Chinese investors, as well as for corporates raising capital, which may hamper the continued development of China's equity market, and more broadly, the domestic economy.

1b. Trading suspensions

During the height of market volatility in the summer of 2015, on some days trading in over half the stocks was suspended. This exacerbated market anxiety, which spilled into other products domestically, as well as markets globally. Suspensions cause problems for the obvious reason that a suspended stock cannot be bought or sold. For fund managers, widespread suspensions can be a major hindrance to meeting fund redemption obligations.

⁹ "Enhancing Liquidity in Emerging Market Exchanges." World Federation of Exchanges, 2016.



Total Suspension of A-shares (2015–2016)

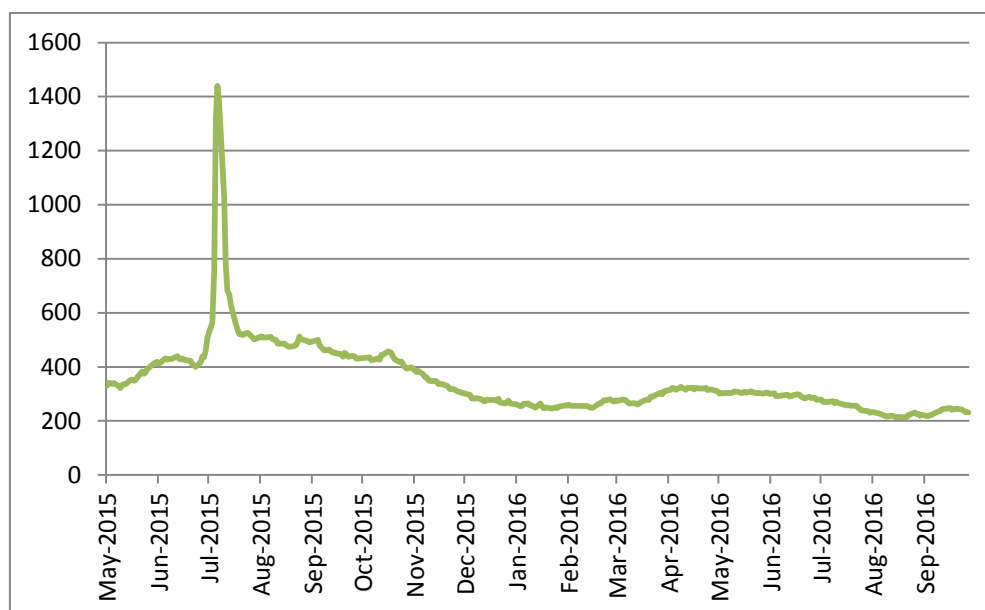


Figure 5: total A-share suspension from May 2015 to Aug 2016
Source: WIND

New rules on trading suspensions introduced in May 2016 were a welcome development. However, investors will be looking to see how the new rules are implemented under a variety of market conditions. This was alluded to by MSCI in its 2016 market classification review and its decision not to include A-shares in the MSCI Emerging Market and other Indices. While we recognise that a listed company has a right to suspend trading of its shares under specific conditions so that investors have time to digest the significance and implications of such conditions, it is particularly important to foreign investors to know that the liquidity of its shares they hold is reliable. The rights and interest of investors, and the liquidity of the market, should prevail over the rights and interest of listed companies.¹⁰

1c. Short selling and stock borrowing and lending

Rules against naked short selling are used globally and are defensible. However, the common prejudice against covered short selling is as unjustified as it is widespread. Academic consensus backed by extensive empirical evidence has documented that short selling is an essential component of well-functioning equity markets.¹¹ For one thing, short selling is not just used to express a bearish view of the market, but is also a crucial risk management tool: many short sales are part of strategy in which an investor is both long and short and is simultaneously buying and selling or to hedge a long stock portfolio. A related example is market-making, in which short sellers provide liquidity to the market when demand spikes and then buy to offset the short positions when demand drops. Such market-making is inherently stabilizing.

¹⁰ "MSCI Consultation on China A-shares Index Inclusion Roadmap." MSCI. June 2016.

¹¹ For example, in his Nobel acceptance speech, William Sharpe made the point that the ability to sell short is a pre-condition for market efficiency. For an excellent overview of the evidence on short selling, see "A Positive Economics View of Short Selling", Robert J. Bianchi and Michael E. Drew, *Banks and Bank Systems*, Volume 7, Issue 2, 2012.



The global financial crisis provided regulators and researchers with a plethora of information to assess the usefulness and impact of restrictions on short selling. The overwhelming consensus from that and other experiences is that short selling restrictions fail to restrain market declines or ameliorate volatility. In fact, restricting short selling creates significant costs and other harm to the market. Market corrections occur because of a change in perception by participants who respond by selling stocks, and short sellers typically play a valuable role in markets by helping to moderate wide swings away from fair value in both directions.¹²

While not prohibited in China, short selling is cumbersome and all but impracticable because the stock borrowing and lending (SBL) market is inefficient and expensive. Short selling in China will only become feasible when there is a reasonably efficient market for SBL and margin financing. Industry, exchanges and regulators should collaborate to develop rules and mechanisms to bring about such an outcome.¹³

Short Selling Outstanding Balance Compared with A-share Market Cap (2013-2016)

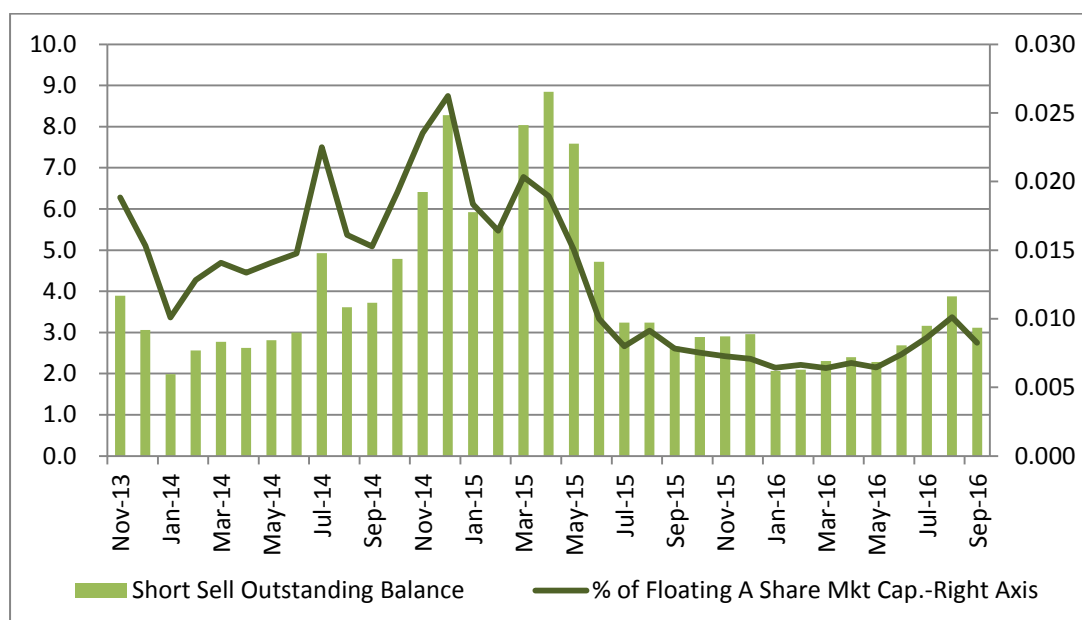


Figure 6: Short selling outstanding balances in RMB billions compared with percentage floating A-share Market Cap on Right Axis from Nov 2013 to Sep 2016
Source: WIND

1d. Institutional investor participation

Increasing institutional investor participation in China’s equity markets would be most beneficial, as a diversified investor base promotes stable shareholding and healthy liquidity. Institutional investors have different investment perspectives and time horizons from retail investors. They are less prone to pursuing market fads or to herding during market stress. In the aftermath of China’s market volatility in 2015, a number of knowledgeable observers correctly advocated increasing the presence

¹² A survey of academic studies is provided in Bianchi, Robert J. and Michael E. Drew, Banks and Bank Systems, “A positive economics view of short selling” Volume 2, Issue 2, 2012.
¹³ ASIFMA White Paper: The Through Train: Stock Connects Impact and Future.” ASIFMA, December 2014.



of long-term institutional investors as a way to boost sentiment in the market. Encouraging the participation of insurance companies and pension funds would also help build the social safety net that is needed to protect the average citizen.¹⁴

Foreign institutional investors, in particular those that have substantial assets under management, will tend to be very cautious and require clarity and certainty about the rules and regulations that apply to their investments in China. Confidence on the part of investors that liquidity will be there when they need it and that they can readily enter and exit the market with minimal restrictions would go a long way towards engendering increased confidence and attracting and retaining long-term institutional investors.

1e. Multilateral trading facilities (MTFs) and alternative trading systems (ATs)

Institutional investors are driven by the need to manage impact costs of trading and employ a range of tools and strategies to do so. Among such tools are MTFs and ATs, trading venues other than conventional stock exchanges with alternative matching rules and mechanisms. A variety of trading venues including MTFs and ATs contribute to an equities ecosystem attractive to institutional investors not only by providing multiple sources of liquidity, but by encouraging competition among service providers, as experience has shown in the US, Europe, and Australia. MTFs and ATs, where available, may provide extended hours, specialised forms of market data, different matching algorithms, and so on. A choice of trading venue will tend to improve the quality of services provided to investors, and brings increased efficiency along with lower costs.

1f. Circuit breakers

The Chinese stock markets had only a brief experience with circuit breakers in the early days of 2016 owing primarily to the fact that the second-level trigger was only two percentage points away from the first-level trigger. Anticipating that the market would quickly move the additional two percentage points to the second trigger level after the market re-opened following the first trigger, market participants accelerated their sell orders, bringing about the very volatility the circuit breakers are intended to prevent. This phenomenon of market participants adjusting their trading strategy in anticipation of a halt is described in an IOSCO report as the “gravitation effect” or “magnetic effect”.¹⁵ The China Securities Regulatory Commission (CSRC) alluded to it in its statement announcing the suspension of the circuit breaker system.

Notwithstanding China’s early experience, we believe a well-designed circuit breaker structure is a useful risk-management component of the overall equity market structure. Major markets around the world have adopted different approaches to circuit breakers, hence there is no single “right answer”. European markets for the most part use dynamic mechanisms for individual stocks but lack market-wide circuit breakers. The US and Japan have both. Perhaps the one generalisation that can be made is that there has been a tendency to try to minimise market closures by keeping dynamic

¹⁴ Choudhury, Salheli. "Institutional investors key to Chinese market recovery: Nasdaq chief." CNBC, September 30, 2015.

The president of NASDAQ was one of the knowledgeable observers cited in the article.

¹⁵ Effectiveness of Market Interventions in Emerging Markets, Final Report, OICV-IOSCO, Emerging Markets Committee of the International Organization of Securities Commissions, FR09/10, October 2010.
<http://www.iosco.org/library/pubdocs/pdf/ioscopd333.pdf>.



halts short (usually one to five minutes) and for making the maximum limit move for market-wide circuit breakers relatively large (in the US the bands are at seven percent, 13 percent, and 20 percent).

In China's case, because individual stocks under current rules are already subject to a maximum 10 percent daily price move, the risk of a major price break is already contained and circuit breakers unnecessary. However, we would make the following recommendations for any revised circuit breaker mechanism:

- If circuit breakers are re-introduced, increase the limits for individual stocks and widen the trigger levels for the circuit breakers
- Assuming increased limits for individual stocks, place circuit-breaker levels far enough apart to avoid the magnetic effect, e.g., seven percent, 15 percent, 20 percent
- Unless the last and final trigger level has been triggered (e.g. 20 percent in the above example), suspend the circuit breaker mechanism in the last 15 minutes of trading to allow a market-based close
- Avoid closing the market for the rest of the day except under extraordinary circumstances by designing the structure with multiple levels and the last level much wider than under the original design
- Make the opening auction following a circuit breaker transparent by disseminating indicative prices and matched volume; that is, make the auction as transparent as the opening auction
- Do not roll a morning closure into the afternoon session as the lunch break provides the necessary pause
- Coordinate the cash and futures market closures so that one market is not trading when the other is halted

2. Primary markets

As of October 2016, over 800 Chinese companies had submitted applications to the CSRC to go public and issue shares. Another 700 or so were queued to add their applications once they get the green light at the provincial level. The CSRC seeks to manage the pace of listings to keep the additional supply of shares from exerting excessive downward pressure on the market. Several times over the past few years, such as in 2012 and again during the turmoil of 2015, all further listings were suspended for some months.

Orchestrating the timing of public listings by a government authority is unique to China among major markets and introduces undesirable distortions into the capital-raising process. The most obvious distortion is that it prevents companies from raising more capital when their boards and managements think they need it. During those windows when the green light is on and companies are permitted to list, the uncertainty dials up the urgency since companies do not want to risk missing what could be a fleeting opportunity. It would be better to let investors and would-be issuing companies determine listings on their schedule, based on their need for equity capital and their perceptions of market conditions. Impediments to listing also create powerful incentives to seek alternative financing routes—such as “backdoor listings” (reverse mergers), greater reliance on debt or even more creative financing strategies. Finally, the approval process itself is inherently



more opaque than a rules-based approach and runs counter to the widely-held goal of making financial market rules as transparent as possible.

The authorities have indicated they will at some point transition to a registration system rather than one based on application and approval. We believe that would be a positive step.

2a. Pricing of IPOs

This is an area of regulation that differs sharply from other major capital markets.

Chinese IPOs are priced prior to trading in the secondary market by way of a regulatory ceiling on valuations. Clearly this is unlike the convention of capital markets of North America, Europe and elsewhere in Asia whereby market forces determine the pricing of IPOs. While China's cap on valuations was designed to protect retail investors, the reality is that the policy has resulted in dramatic under-pricing (discounts) of IPOs that surge in price in the secondary market, essentially creating regulation-driven gains immediately upon listing. Who the winners and losers are is obscure due to the lack of transparency.

In addition to the IPO pricing policy, the Chinese regulatory limit on one-day share price gains in the secondary market contributes to inefficient capital markets because IPO discounts narrow over several market sessions rather than adjusting immediately as in other major markets. As of early 2017 the one-day share price limits are set at 44 percent on the first day and 10 percent thereafter. The extent of the inefficiency of the pricing of Chinese IPOs is evident from the fact that all 99 new listings on the Shenzhen Exchange in 2016 climbed by the daily limit on their trading debut.

2b. Delisting of sub-standard companies

Clear rules and consistent implementation of a process for delisting illiquid and sub-standard companies—those that no longer meet listing requirements — are crucial. From 1995-2016, China delisted only 0.8 percent of total listings. This is a small amount compared to global rates that range as high as 10 percent and above and suggests that some substandard companies remain listed on Chinese exchanges that should not be.

The authorities recognised the shortcomings of the delisting process and in 2015, the CSRC introduced new rules that require more information disclosure and delisting for illegal acts and fraudulent issuance. On 21 March 2016, authorities delisted ST Boyuan from the SSE due to illegal disclosure of important information. This was encouraging and we look forward to the continued consistent application of the new approach.

Percentage Comparison of Delisting Rates by Country (1995-2016)

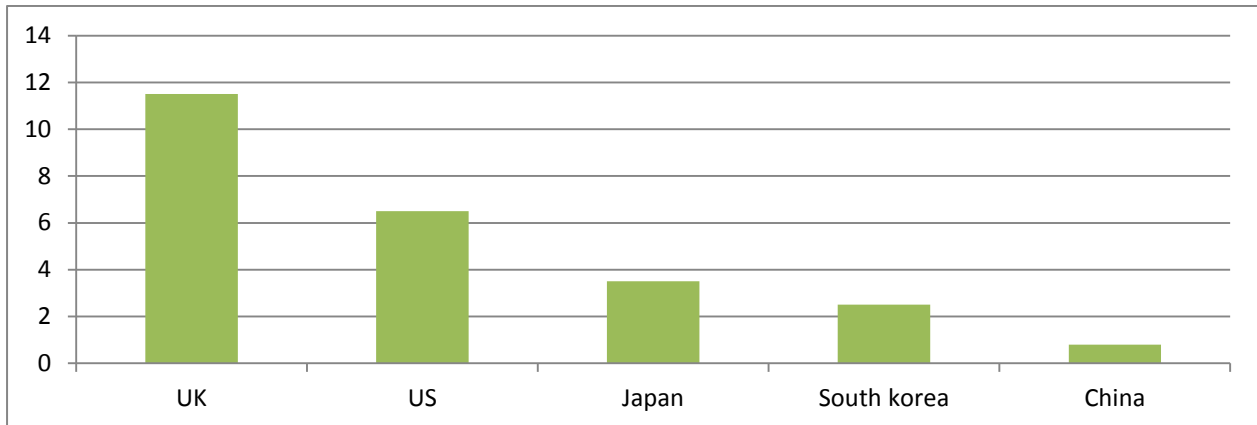


Figure 7: Delisting percentage by country from 1995-2016
 Source: PEdaily.cn

3. Ownership limits

China's 10 percent foreign ownership limit presents a form of execution risk that adds to the risk of investing in China A-shares. In addition, the aggregate of all foreign investment in a listed company must not exceed 30 percent of the company's total outstanding shares. Currently, if that limit is breached, it is unlikely that the owner would be notified until the end of the trading day, after which a forced sale procedure would be implemented to bring the foreign ownership back below 10 percent or 30 percent as the case may be.¹⁶ This is operationally complicated and creates problems for institutional investors managing their investment mandates. Ownership limits are used by countries around the world for companies that represent a strategic interest. However, they tend to be overused and retained long after the original reasons have become obsolete. For all these reasons, we believe the use of ownership limits should be minimised to the extent possible.

3a. Short swing profit rule

In those few jurisdictions where directors, senior managers and substantial shareholders (e.g. holders of five percent or more shares) of a listed company are subject to a short swing profit rule (e.g. where they are required to disgorge any profit from the purchase and sale of shares of a listed company within a six-month period), there are exceptions for investment managers, or alternatively holdings under such rules are calculated on an individual client/fund basis and the rule is triggered at a higher percentage threshold. If the holdings of separate clients/funds have to be aggregated because they happen to be managed by the same investment manager (or an investment manager that is part of a group of investment management companies), as is the case for disclosure of interests in China, the five percent threshold may be reached much sooner, thereby preventing further investment by the investment manager on behalf of all of its clients/funds in the relevant securities. This result unfairly harms investors whose investment manager is impacted by the rule, e.g. those investment managers who manage investments for multiple clients/funds or are part of a group of investment management companies. It also has the effect of reducing the amount of

¹⁶ "ASIFMA White Paper: The Through Train: Stock Connects Impact and Future." ASIFMA, December 2014.



potential investment from large global asset managers, which are an important source of long-term capital.

For the ongoing reasons it is important to clarify, for purposes of the China short swing profit rule, that holdings are calculated on an individual client/fund basis and not aggregated across the investments made by an investment manager on behalf of all of its clients/funds or across the investments made by a group of affiliated investment management companies.

4. Settlement of trades

China's equity market is unique in that stocks are settled on the day they are traded, on T+0. Cash, on the other hand, settles the next day, on T+1. This system is admirably efficient and works because China requires all the shares and cash to be fully "prefunded" before the investor could place a buy or sell order. However, for investors this practice creates "cash drag", a degradation in investment performance since the prefunded cash will earn little or no return. Prefunding also creates trading inefficiencies due to the need for additional pre-trade checking to ensure cash and securities are available before the trade is placed. In most markets, investors have no prefunding requirement; hence trades can be executed immediately. Time-zone differences exacerbate the operational challenges.

Most markets take longer to settle stocks and cash but in these other markets, settlement of stocks and cash occurs simultaneously and with sufficient time lag following a trade for counterparties to confirm trades, arrange for delivery of FX as needed, to transfer cash, correct problems, and to settle. Europe moved to a T+2 cycle in 2015 and the US will follow suit in 2017.

Another important effect of the discrepancy in the timing of cash and securities is that it gives rise to counterparty risk. The investor selling a security is subject to counterparty risk vis-a-vis his broker for a day. If the broker finances the sale proceeds for the client by delivering the cash on T+0 to eliminate this risk for the client, the broker incurs financing costs and takes on counterparty risk vis-a-vis the exchange clearing house.

To alleviate some of the operational challenges some investors may choose "single-sided" settlement, in which the investor places standing instructions with the custodian to settle the trade based on the broker's specific instructions ("allegements"). However, this may create new challenges for both client and broker, including a reduced control over the shares or cash in the fund by the client, reconciliation issues or potential duplication of instructions. Another problem is that because the outcome of an order is always uncertain, the treasury of a brokerage firm in another time zone will have difficulty funding trades because it cannot with certainty forecast an order's funding requirement. This raises the cost of funding or forces the broker or investors to prefund their order, creating the aforementioned "cash drag". This cycle contrasts with the "delivery versus payment" (DVP) settlement process used in most other markets, where transfer of shares and money occurs simultaneously. In addition, standard settlement for the RMB spot market is T+2 in China, as in other FX markets. The difference between FX and stock settlements creates another added cost for foreign investors who have to convert currency on a non-standard cycle of T+1 for equity trades.



There is no doubt that settlement differences in the Chinese system create additional costs and risks for non-Chinese investors and their brokers, especially for large long-only investors who typically have multiple custodians.

5. Investor education

It is important for Chinese regulators, exchanges, and brokers to ensure that investors are properly educated about equity investment and risk. Retail investors in particular need to understand:

- That all asset classes have risk—but crucially, also that diversification reduces risk
- That equity investing should be used as just one asset class in a risk-compatible portfolio that includes a number of asset classes
- The importance of having investment objectives, of building a portfolio consistent with those objectives, and of being disciplined about following them
- The importance of costs to long-term portfolio performance

Any expectation by retail investors that government action might “bail them out” of unfortunate investment choices will tend to create “moral hazard”. That is, such expectations promote more risk-taking and less prudence and conflict with the above principles of successful investing. Hence policy makers and industry professionals should avoid creating such expectations.

Recommendations for Equities

1. Rigorously implement reforms in trading suspension rules to ensure stocks continue trading except under exceptional conditions set out in transparently applied rules.
2. Develop a SBL environment to enhance overall equity market efficiency and to enable efficient short selling.
3. Facilitate increased participation by institutional investors by encouraging participation of insurance companies and pensions funds.
4. Allow alternatives to exchanges such as MTFs and ATs.
5. Widen allowable price moves for equities and consider reintroducing circuit breakers.
6. Reform the pricing of IPOs by allowing market forces to determine prices.
7. Adopt transparent rules for delisting sub-standard companies.
8. Clarify short swing profit rule as they relate to fund managers to allow holdings to be calculated on an individual client/fund basis.
9. Move to a settlement cycle where cash and stock settle simultaneously e.g. DVP, to protect investors (e.g. to T+1).
10. Promote investor education programmes that teach key principles of investment such as an understanding of risk, the role of diversification, and the importance of building a portfolio with an appropriate investment horizon.



E. Fixed Income

Despite vast production capacity and trade links with global markets, China lacks depth in its financial sector, exacerbated by a still-developing bond markets. As China transitions to a consumption driven economy, the country will need to further -develop its bond markets to facilitate this transformation.

China has encouraged corporates to raise capital via its equity markets and bank lending at the expense of its domestic bond markets, although in recent years a combination of factors including regulatory and other pressures (such as increasing NPLs on bank balance sheets and a move away from shadow banking) has prompted a gradual move towards bond market financing, at the margin. A fully functioning, open financial market and efficient capital allocation depend on a strong foundation of liquid and transparent bond markets. Mature domestic debt capital markets offer options for funding government initiatives and corporates, and provide an alternative to the over-reliance on bank lending which exists in China today. In particular, developing a deep and liquid government bond market typically creates increased opportunities for other issuers. A well-functioning bond market is one of the useful precursors to relaxing capital controls and facilitating an interest rate-led monetary policy.

The lack of market-driven capital allocation and unequal treatment for foreign institutions in China's nascent bond markets – especially with respect to underwriting, market making, derivatives trading with corporate clients, and bond settlement agent licensing – remain significant obstacles to further development. A more market-driven environment and best practices such as a liquidation regime and disclosures will enhance the development of an efficient bond market. In this regard, opening access to foreign institutions will help bring in their expertise and experiences to promote the evolution and maturity of onshore bond market. This section will detail the need for well-developed bond markets, the technical aspects crucial to functioning government bond markets, the underlying prerequisites of sound financial markets in general, China's recent accomplishments with respect to bond market development, and other issues for further consideration.¹⁷

In September 2016, ASIFMA in association with other global trade organisations¹⁸ conducted a global investor survey on their views of China's onshore bond market. Although the Chinese government has accelerated efforts to attract more foreign investments and improve foreign investor's access, the survey highlights impediments that should be considered to fully open its capital market.

Of the 31 factors that were examined, almost all factors are considered by the respondents as significantly important. In particular, the technical issues were seen as more significant barriers to participation than macroeconomic impediments such as GDP growth. Chinese authorities may therefore wish to take a holistic view when considering policy priorities and the sequencing of their capital market reform agenda.

¹⁷ ASIFMA Paper: China Bond Market Roadmap." ASIFMA, June 2014.

¹⁸ AFME, AIMA, ALFI, Irish Funds, KOFIA and SIFMA AMG



1. State of the market

China's onshore bond market is currently the world's third largest by securities outstanding, behind those of the US and Japan. The onshore market is also substantially larger than the offshore market; the nominal value of fixed income securities issued onshore was RMB 50.3 trillion and the nominal value of bonds issued offshore was RMB 867 billion at the end of February 2016.¹⁹ The size of the onshore market has expanded rapidly, and in 2015 was six times larger than in 2006, according to the Bank for International Settlements.²⁰ Sovereign and government issuers dominated the onshore Chinese bonds until 2005, although both financial and non-financial corporates began to issue onshore bonds from 2008.

Domestic Debt Market Size by Country (2011-2016)

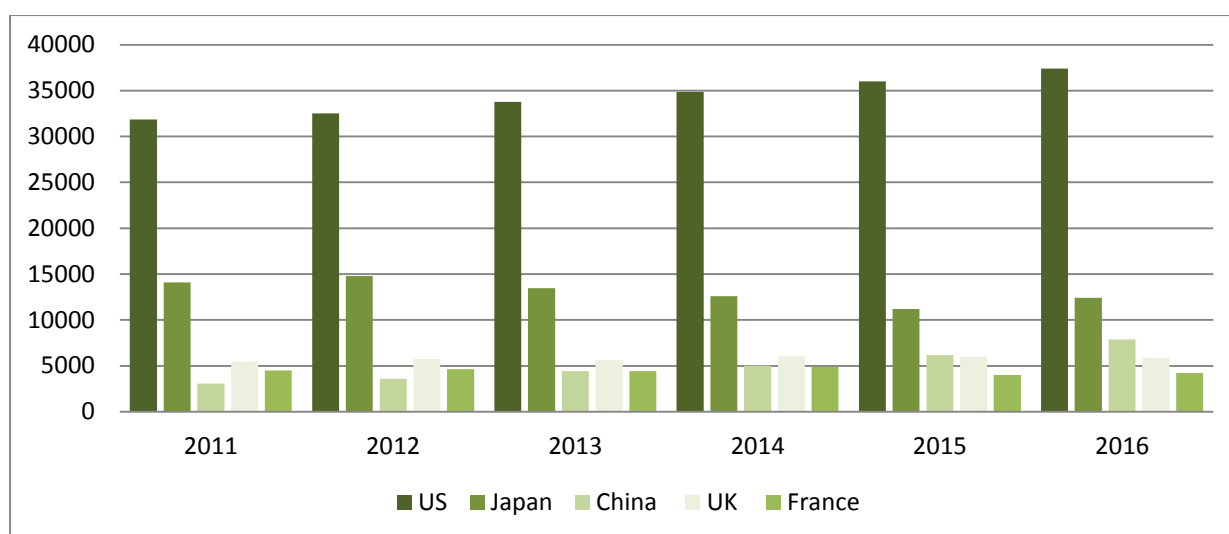


Figure 8: Debt securities outstanding USD billions data captured in Q1 from 2011-2016 (Last seen Oct 12 2016)
Source: BIS

Bond market reform in China has primarily centred on the introduction of new instruments and trading methods. As the market becomes more established, the range of issuers and investors has increased substantially. These market-oriented reforms aim to increase financial disintermediation and help broaden and deepen China's domestic bond markets. The reforms will allow for increased bond market transparency, improved market-based pricing and strengthened market discipline.²¹

2. Types of instruments

China maintains a two-bond-market structure, the interbank bond market and the Exchange bond market, with the interbank market being the much larger of the two. The interbank bond market accounts for approximately 95 percent of the market while the Exchange bond market just five percent. The available bonds in China's market can be grouped into four broad categories:

¹⁹ "The FTSE China Onshore Bond Index Series." FTSE Russell, 2016.

²⁰ "The FTSE China Onshore Bond Index Series." FTSE Russell, 2016.

²¹ Shevlin, Aiden, and Lan Wu. "China: The path to interest rate liberalization." J.P. Morgan Asset Management, 2015.



- Government bonds – issued by the Ministry of Finance (MOF) and which include local government bonds
- Central bank bills – the most actively traded sector of China's bond market and often used in money market and liquidity management portfolios due to the bills' shorter maturities
- Financial bonds – policy bank bonds, commercial bank bonds, and other non-bank financial institution bonds
- Non-Financial corporate bonds – including enterprise bonds, commercial paper (CP) and medium-term notes (MTNs)

3. Interest rate liberalisation

The first step in developing a vibrant bond market is to liberalise interest rates, a process that is well under way in China. The Chinese regulatory authorities have realised that liberalizing interest rates and removing capital controls benefit the development of a market oriented banking industry because it requires banks to diversify, narrowing the net interest margin and shrinking the room for profits. These reforms incentivise banks to lend to SMEs, a sector in which banks enjoy higher returns, to maintain profitability. Additionally, liberalizing interest rates and removing capital controls could help enable banks to change their business models, shifting from relying heavily on income from interest on deposits to focusing on providing comprehensive and diversified services to customers, including capital markets products.²²

While Chinese regulators have taken several steps to liberalise interest rates, with the pace of liberalisation actually picking up over the last two to three years, more needs to be done. Floors on loan rates have been removed, as have ceilings on rates payable. In theory, this should lead to more competition among banks in both deposit-taking and lending. But in practice, such competition is constrained. For instance, well connected SOEs can still borrow at favourable rates, close to the benchmark interest rate. Also, with limited alternatives for savers to invest their cash, in practice, there is not much competition for the deposits of savers either.

3a. Interest rate implications for the markets

In recent years, China's benchmark one-year lending and deposit rates have been significantly lower than the country's nominal annual gross GDP growth rate (6.70 percent in Q3 2016). It is widely held that a country's nominal interest rate should be equal to or higher than its nominal GDP growth rate. Corrections to these imbalances will likely cause interest rates to rise once the deposit rates are liberalised. High interest rates present in the shadow banking sector are a result of liberalised deposit interest rates. This increase will not be confined to current regulated rates, but will also affect market-based rates.

As pointed out above, deregulating deposits should in theory result in increased competition among banks for funding and a sharp reduction in their net interest margins. But as a practical matter, large banks with extensive branch networks and more secure deposit bases may be less impacted by deregulation. Also, large banks are under pressure to protect interest margins, especially in an environment of low and falling rates. On the other hand, smaller banks will need to innovate to

²² "ASIFMA Paper: China Bond Market Roadmap." ASIFMA, June 2014.



increase the range and variety of deposits, in addition to introducing new financial instruments to attract retail funds.

As banks (especially the small ones) lose deposits they look to access capital markets. Reflecting this trend issuance of negotiable certificates of deposit (NCD) volume has reached RMB 9.6 trillion for the first nine months of 2016, accounting for one third of total onshore bond issuance. In 2014, the annual NCD issuance volume was just RMB 0.9 trillion. The Shanghai Interbank Bond Offered Rate (SHIBOR) and the domestic NCD pricing reference rate will become more important and liberalisation will bring about a more accurate reflection of funding costs. Bond yields for governments, policy banks and credit bonds will likely rise, driven by increased issuance and higher competition for funding. This will promote increased secondary trading, liquidity and pricing transparency.

Importantly, the introduction of the deposit protection scheme where deposits up to CNY 500,000 are protected will remove the assumption that the Chinese government implicitly guarantees all domestic banks. However, the government needs to pass bankruptcy legislation to help reinforce this point. This would force investors to develop a better understanding of the link between risk and return.

3b. Interest rate implications for institutional investors

Institutional investors already invest in a broad array of products (including simple time deposits, entrusted loans, wealth management products, money market funds and separately managed accounts), all of which benefit from an implicit government guarantee.

This implicit guarantee has gradually begun to erode as the interest rate liberalisation process got under way and will disappear entirely when interest rates are fully liberalised. The change will have a profound impact in the market environment, including dispelling investor complacency, creating rate uncertainty and forcing market participants to re-evaluate counterparty and credit risk, as well as the risks inherent in investment policies. The implementation of the new interest rate policies will likely be gradual, giving investors ample time to decide on a strategic approach and introduce necessary controls and procedures. In the short term, most institutional investors will likely be more conservative in their investment choices.²³

4. Primary market

Bonds can be issued in two ways in China: by tender, through the issue system of the People's Bank of China (PBOC), and by book building. Treasury bonds, financial bonds and policy bank bonds are issued by tender through the PBOC's issue system. The State Council, MOF and PBOC share responsibility for the issuance guidelines of Treasury bonds. The State Council and MOF determine the annual issuance size of Treasury bonds. As for financial bonds, the PBOC verifies and approves issuance. Financial bonds can be issued either at once or in instalments under specified quotas. There are no maturity restrictions for Treasury bonds, policy bank bonds and financial bonds.

²³ Shevlin, Aiden, and Lan Wu. "China: The path to interest rate liberalization." J.P. Morgan Asset Management, 2015.



The issuance of shorter-tenor non-financial instruments such as Short Commercial Paper (SCP), CP and MTNs is regulated by National Association of Financial Market Institutional Investors (NAFMII), under the supervision team of the PBOC. Following a one-time registration these instruments can be issued in instalments within two years. Securities are issued either via tender or through book building. In terms of maturities, SCPs have a maximum maturity of 270 days; CP has a maximum tenor of one year and while MTNs have no maximum maturity, they are usually no longer than 10 years.

Credit products, typically listed corporate bonds, are issued through book building. One key characteristic of book building in China compared with book building in developed markets is that in China the process resembles a formal auction. The CSRC regulates the issuance of listed corporate bonds through a verification and approval process. Non-enterprise corporate bonds are largely listed and traded on the exchange markets, unlike the other categories of bonds which are for the most part traded on the interbank bond markets. A requirement is that funds raised should be used in conformity with national industry policy. There are no maturity restrictions for listed corporate bonds.

Finally, the issuance of enterprise bonds is regulated by the National Development and Reform Commission (NDRC). The NDRC previously regulated SOE issuance through a formal verification and approval process, but in 2015 the NDRC relaxed guidelines allowing for issuance of enterprise bonds following a registration process. The State Council determines the approved size of the issuance. The issuer determines the rate after taking into account market conditions. Finally, while there are no restrictions on tenor, these are normally longer tenor issuances with maturities longer than 5 years.

Administration of bond issuance in China's bond market is governed by several statutes, categorised into Treasury bonds, financial bonds, non-financial enterprise debt-financing instruments (including SCP, CP, MTNs, and private placement notes), listed corporate bonds, enterprise bonds, and non-financial enterprises issuing debt instrument by private placement.

Following the formation of NAFMII, a series of rules and guidelines regarding issuance and underwriting, information disclosure, credit rating and market transactions of debt-financing instruments were established for the interbank bond market. NAFMII, under PBOC guidance, has overseen the development of this market. As a consequence, the issuances of all categories of bonds described above (except for treasury bonds) incorporate a due diligence process and have several categories of information disclosure requirements including a prospectus, audited financial statements, details around specifics related to the issuance, the proposed use of funds and other related requirements. Likewise, all bond issues (except for treasury bonds) require both an issuer and an individual debt rating provided by a local credit ratings agency, as one of the conditions for issuance.

Foreign institutions have limited access to underwriting bonds. Previously, foreign banks and their joint ventures were allowed to underwrite government bonds, central bank bills, CPs and MTNs and financial corporate bonds. But foreign institutions were barred from underwriting non-financial corporate bonds on China's interbank market until 2011, when a limited number of such institutions were granted permission by NAFMII to carry out such underwriting activity. Access remains



restricted, but allowing more foreign institutions – including foreign securities firms – to underwrite financial and corporate bond issues in China's domestic market would help the market's further development.

The functioning of the primary market can be further improved as follows:

- Adoption of international best practices with respect to issues such as information disclosure, which could actually be simplified for institutional investors, who do not need the same level of detail provided to retail investors, both in the prospectus/issuing document at the time of the new issue and on a continuing basis
- Strengthening the due diligence process, in particular the key areas of financial (pertaining to the issuer's financial accounts), legal (issues pertaining to the incorporation of the issuer) and business (pertaining to the present and future outlook/prospects for the issuer's business activities) due diligence
- Streamline the bookbuilding process to provide more flexibility in terms of price determination through an iterative process of communication between the issuer/underwriter(s)/bookrunner on the one hand and investors on the other hand, similar to the process used in international offerings

5. Secondary Market

The establishment of a secondary market for government bonds is integral to the overall development of the Chinese bond market and is one of the concerns of respondents to the ASIFMA global investors' survey. Benefits of developing a deep and liquid secondary market include: establishing risk-free reference yield curves and risk-free assets (e.g. government bonds), supporting the development of sound corporate debt and money markets, and enabling the government to borrow for longer terms at lower funding costs. This would further the government's ability to fund large infrastructure projects and urbanisation programmes. Additionally, the secondary market promotes financial stability and lowers systemic risk by acting as a shock absorber during crises and facilitating cost-effective risk management for market participants.

Government bond secondary market liquidity relies on seven basic requirements:

- Disciplined issuance and reissuance programmes to support large benchmark issues
- Liquid "classic" term repo markets that allow short selling of government bonds
- Active, liquid government bond futures markets
- A broad range of liquid OTC derivatives contracts and exchange-traded derivatives contracts
- High-quality, efficient and cost-effective electronic price discovery, trading, clearing and settlement platforms
- A broad, active domestic and foreign investor base (e.g. pension funds)
- Market-friendly regulatory, accounting and tax regimes, including no withholding taxes and no transaction taxes

The PBOC and MOF have implemented rules requiring market makers to display two-way quotes on the four most recently-issued government bonds for each benchmark tenor, which has enhanced market liquidity. Nevertheless, the secondary government bond market still suffers from a lack of



liquidity due to the hoarding of bonds by Chinese banks to meet bank liquidity requirements as well as other factors mentioned.²⁴

6. Benchmark yield curve

Benchmarks play a critical role in the efficient functioning of both the primary and secondary bond markets. They are used as a bellwether to gauge the predominant interest rate structure, the market's expectations for future interest rate fluctuations and inflation, and provide hedging vehicles against certain market risks. The existence of a common benchmark yield curve, grounded on a liquid government bond market, is a key element for the financial sector to reach efficient capital allocation and for government policy makers to gauge market expectations, as much of the analysis and pricing activity that takes place in the bond markets revolve around the yield curve.

A benchmark yield curve currently exists in Chinese markets for the most actively traded bonds across a range of maturities called the "on-the-run" issues, but the accuracy of the benchmark is suspect. The MOF has recently improved its issuance schedule for all key tenors to a regular calendar, but each issuance size is still relatively small considering market demands and in comparison to other government bond markets such as US Treasuries. Besides, China's commercial banks perform their asset allocation by buying government bonds and holding them until maturity. All these factors have resulted in a limited amount of "on-the-run" Chinese government bonds (CGBs) available for trading in the secondary market. Market participants have expressed concern that this dynamic renders the yield curve effectively meaningless because the yield on these bonds does not reflect market conditions.

The government yield curve is flat, reflecting the lack of proper pricing of the term premium for long-dated government bonds. Since yields across the curve are similar, market liquidity tends to be concentrated in the one- to three-year part of the curve. Establishing liquid and transparent pricing at the 5- and 10-year tenor points is critical for market participants like insurance companies. Pricing for more sophisticated instruments is also facilitated if there is a proper yield curve.

ASIFMA strongly urges regulators to broaden the range of financial instruments that can be used to satisfy bank liquidity requirements. Meanwhile, actions to increase the issuance size and providing encouragement to market makers to provide pricing transparency are all important steps to developing a strong China benchmark yield curve.

7. Classic repo market

A classic bond repurchase (repo) market refers to a system within which margining of exposures is standard practice and the bond title is actually transferred as part of the repurchase agreement. This allows market participants to use the bonds they own for additional purposes, such as market making, further repos, covering short positions, securities lending or collateral. A pledge repo system does not allow these activities as the title is not transferred.

In China, the pledge repo system dominates which means that the bonds cannot be re-used. This reduces liquidity and collateral optimisation, stifling the development of a more liquid repo market.

²⁴"ASIFMA Paper: China Bond Market Roadmap." ASIFMA, June 2014.



Another consequence is concentration of risk in shorter tenors and a lower incentive for the market to broaden out across a more varied counterparty type. In the meantime, since buyers do not have the explicit right to liquidate collateral assets or set-off in the event of a seller default, buyers are prevented from reducing their counterparty credit risk and liquidity risk exposures. Pledge repos therefore do not fully protect creditors' rights in bankruptcy or insolvency proceedings. The use of pledge repos is also discouraged as there is the potential for the collateral security to be re-pledged to multiple counterparties without their knowledge as the pledge agreements do not afford the full transfer of ownership of the underlying assets.

We emphasise that the ability to go short is fundamental to market-making. Not all market-makers, which are critical for developing liquidity in any market, have access to every instrument in their inventory at any given time. Nevertheless, classic repo markets give market makers the ability to quote a price to a client if they are confident in their ability to borrow and deliver that instrument at a good price. This significantly enhances liquidity in the cash market, and thereby serves as a prerequisite for the maturation of the bond futures market and the OTC derivatives market, which requires a sufficiently liquid cash market. Repos also allow primary dealers to hedge risk with a wider array of hedging strategies. Importantly, because repos are secured transactions, they broaden funding markets and serve as a critical link between money markets, bond markets, futures markets and OTC derivatives markets.

Repo transaction volumes in China grew throughout 2015 but remained relatively short-term. As mentioned, the majority of transactions were pledged as a security and involved no title transfer, so they did not function as true repos. The interbank market is the dominant trading venue for fixed income repos. However, there is no current margin payment mechanism or collateral mark-to-market process, which necessitates higher haircuts to compensate, resulting in limited liquidity for longer tenors. Moreover, China's repo market still suffers from an unstable repo rate. This is largely the result of the PBOC's preference for using quantitative monetary instruments over "price" instruments, which makes it very difficult for market participants to price risk accurately and trade interest rate swaps based on a seven-day repo fixing. The PBOC currently has restrictions on onshore banks executing reverse repo with offshore investors, halting offshore participation in the market which would have brought additional liquidity and depth in the CNY repo markets and ultimately more stable repo rates with more participants enter the market. Recent efforts to reform and develop China's repo market, including NAFMII's introduction of local Global Master Repurchase Agreement and the NAFMII Documents, are important steps in the right direction, but a fully liquid and active classic repo market has yet to develop in China.²⁵

A liquid and deep repo market would help deepen capital markets and support the real economy by:

- Increasing liquidity and participation in local currency bond markets
- Expanding the pool of available financing away from an over-reliance on bank lending and improving financial institutions' ability to meet their financing needs
- Mitigating reduction in market liquidity due to regulatory change
- Reducing funding costs for governments, pension funds, asset managers and other long-term investors

²⁵"ASIFMA Paper: China Bond Market Roadmap." ASIFMA, June 2014.



- Developing market infrastructure necessary to serve the real economy
- Offering hedging tools which contribute to risk management
- Improve securities mobility to counter the adverse effects of increased requirements driven by regulatory change, including Basel III, new asset segregation rules and central clearing mandates²⁶

A classic repo market is required to develop liquidity in the secondary market, which is a key concern for the respondent of our global investor survey. Bond lending currently takes place on a bilateral basis between banks and their clients and is often used for switching lower rated corporate bonds into CGBs, which are more liquid within the interbank repo market. These transactions are covered under bilateral bespoke agreements between counterparties. Introduction of a standardised lending agreement, similar to the Global Master Securities Lending Agreement format, would help improve liquidity.

8. Bond futures market

An active, liquid, and well-supervised government bond futures market would allow participants to hedge large positions quickly and reduce risk more effectively, while deepening the underlying bond and derivatives markets. Availability of hedging instruments is key to attracting international investors, our recent survey confirmed. Based on other countries' experiences, bond futures enhance the liquidity of the underlying cash markets as market participants are able to manage risks of their bond inventories more effectively. Additionally, bond futures markets are especially beneficial to market-makers because futures enable them to hedge their positions, thus reducing risk and allowing them to offer tighter bid-ask spreads. China launched 10-year government bond futures on the China Financial Futures Exchange (CFFEX) in March 2015, two years after officially listing five-year government bond futures for trading. However, to date, neither domestic nor foreign banks are allowed to participate directly in the futures market. As Chinese banks own the vast majority of government bonds, this hampers liquidity and therefore undermines the use of futures as a cheap and effective way to hedge.²⁷

9. Fixed income derivatives

Interest rate derivatives are effective instruments for CIBM investors to manage interest rate risk and asset/liability mismatches. The interest rate swap curve has been the core pricing component for the entire financial derivative market. It has been 10 years since the PBOC launched the RMB Interest Rate Swap (IRS) product, and now the market has become sophisticated enough with a wide range of market participants and an efficient electronic trading platform for trade confirmation and settlement.

As the scale of domestic interest rate swap trading grows, factors that restrict IRS market development gradually appear. To align with the current international OTC derivatives market standards, CFETS proactively launched the IRS offsetting and electronic trading confirmation business in 2012 based on in-depth research on international experience, and required market participants to join the central clearing system as counterparties in 2014. By doing so, CFETS has

²⁶"ASIFMA-ICMA Guide on Repo in Asia." ASIFMA and ICMA, August 2015.

²⁷ASIFMA Paper: China Bond Market Roadmap." ASIFMA, June 2014.



effectively upgraded the standardisation of interbank IRS trading, reduced overall market risk and improved market members' capital efficiency and credit management efficiency. This represents significant progress in the development of the interbank market infrastructure.

The onshore IRS market mainly trades with two underlying benchmark interest rates used to calculate the floating-rate leg of the swap – FR007 (which is the 2-7 day repo rate) and the SHIBOR with tenors up to 5 years. These benchmarks are quite market-oriented and prices for standard tenors can be readily obtained from money broking firms and from the pages they post on financial information providers like Bloomberg and Reuters. Generally speaking, market liquidity for IRS on FR007 is good and the market has become more active with diversified investors, securities companies in particular.

However, as the market-oriented reform process pertaining to RMB interest rates comes to an end, the volatility of interest rate fluctuations increases and accordingly, risk management becomes a tougher task for commercial banks. The introduction of other innovative financial products also imposes additional risk management burdens. In particular, the capacity of financial institutions to price longer-tenor instruments faces challenges.

On the other hand, most of the funding cost of corporates is based on neither FR007 nor SHIBOR, but on the benchmark lending and deposit rates issued by the PBOC, which are not frequently adjusted. Products which are priced off the underlying deposit and loan rates published by the PBOC are not widely accepted by the market, leaving a significant part of corporate assets and liabilities unhedged. The current pricing of FR007_IRS is more from the perspective of where short-term money is quoted, hence an imperfect hedging instrument for longer-tenor bond investors. The inability of banks to access the futures market for hedging purposes is a negative and further hampers effective risk management. However, this could change in the future.

Going forward, with the progress of financial product reform in Shanghai Free Trade Zone (FTZ), opportunities to develop Non-Deliverable Interest Rate Swaps products or the possibility of offshore financial institutions participating in onshore IRS markets would be welcome developments (something which is specifically contemplated in the context of the recent opening of CIBM to a wide range of eligible investors). Also the need for SHIBOR_3M IRS products will increase with more bond issuance based on such underlying. Finally, the ongoing process of interest rate liberalisation will act as a catalyst for market participants to focus on better management of interest rate risks.

There has also been significant progress on hedging credit risks. In September 2016, NAFMII has issued guidelines pertaining to the introduction of CDS, Credit-Linked Notes, Credit Risk Mitigation Agreements and Credit Risk Mitigation Warrants. An institution is able to participate in the credit derivatives market if it is a member of NAFMII. NAFMII is a repository of credit derivatives trade data under these new guidelines as all relevant trades must be filed with NAFMII. There are also disclosure requirements in the newly introduced CDS framework.

As of now, there are two categories of market participants under the NAFMII framework: "Core Participants", who can trade with all other market participants and "Normal Participants," who can trade only with the "Core Participants." Financial institutions and Credit enhancement institutions are considered to be "Core Participants".



The introduction of onshore CDS is timely as Chinese entities, including one SOE and a number of corporates, have defaulted on their debt obligations in 2016. As CDSs allow market participants to “insure” against default risk, they have been a useful hedging instrument. More, however, needs to be done to develop the CDS market. Chinese authorities should consider:

- Issuing guidelines for offshore investors and other market participants to use the Chinese domestic CDS market
- Formalising the central clearing of CDS and the designation of Central Counterparties (CCPs) to mitigate counterparty risk

10. Price discovery, trading and clearing and settlement

High-quality and cost-effective price discovery is a crucial component of a liquid secondary bond market. Additional components include electronic trading, clearing and settlement platforms, which as per IOSCO best practices, must be clearly demarcated. While there has been progress in developing these components, much remains to be done. Price and credit information is available onshore through providers such as Wind but much of the pricing is indicative only and deviates quite substantially from the real price when market participants wish to trade. When trades do happen, they all need to be registered on CFETS (whether traded on that platform or not) which is an additional administrative and cost burden that is not generally seen in other markets. By far the largest share of Chinese bond market transactions are traded OTC in the interbank bond market and registered on CFETs. These instruments include government bonds, central banknotes (CBNs), financial bonds, enterprise bonds, CP and MTNs.

Focusing on the interbank bond market, which is the dominant bond trading venue, the CFETS trading system is very expensive by international standards and not generally user friendly. Much of the liquidity is found on chat rooms or with brokers that, unlike in the global markets, trade with anyone and not just dealers. As a consequence, dealers are not sure to whom they are providing liquidity, which may undermine their desire to do so. Chat rooms are also based on individual relationships where market participants may be excluded for any reason, creating a market with asymmetric information. For the exchange market, investors can trade bonds on the SSE and SZSE. These markets are not liquid and likely will remain illiquid, given that exchange trading has not worked for bonds anywhere in the world.

Finally, the clearing and settlement systems are expensive and manually intensive. Each of China Central Depository & Clearing Co., Ltd. (CCDC) and SHCH provides bond registration, depository and settlement services for the interbank bond market. For bonds listed on the exchange-traded market, the CSRC directly supervises China Securities Depository and Clearing Corporation (CSDCC), which acts as the clearing company of the SSE and SZSE. Depository and custodial services for the exchange-traded market are also provided by the CSDCC.

In addition, these clearing and settlement market infrastructures impose different practices, communication protocols and sometimes data standards making them even more costly and risky for the market participants. For instance, internationally, clearing members and settlement members or depository participants are segregated and different entities can perform the functions as specialists. In China, these roles can only be performed by Type A members.



Taken together, all these costs, administrative burdens and asymmetric information undermine liquidity as it is difficult to gauge the true cost of trading and settlement. Market participants are consequently reticent to trade in the volumes seen in developed markets, which are commensurate with a liquid secondary market. We would therefore make the following recommendations:

- The role of the Type A member can be split between trading and settlement functions, to allow specialist trading and settlement service providers to independently service the client
- Type A members can be members at CFETS for trading/trade matching purposes, only if the trade is sourced and executed by such members. They can also provide settlement functions, if they chose to. However the functions need not be bundled
- Broker dealers, asset managers or investors should be allowed to trade and enter CFETS for trade matching on behalf of investors
- Custodians should be allowed to provide settlement services at the depositories using their existing license, which is allowed in almost every other market globally. They can also be required to do trade reporting for OTC trades at CFETS so CFETS has the entire trade and execution data, if required
- Trade execution or services that can impact the legality of the trade execution in the market would not be allowed
- Investors should be allowed to enter trade orders in CFETS overseas either by themselves or through their broker/GC/ICSD, using the trading ID of the intermediary or their own. Alternatively they can trade onshore through the onshore Settlement Agent
- A Central Clearing Counterparty for all OTC trades in the CIBM should be considered with Clearing Members who participate in the Clearing process to minimise clearing risks (for CCDC settlements)
- Type A members and custodian banks should be eligible to become clearing members for bond trading upon application. This would be on a par with the equities market framework in China and also international best practices
- Investors should settle the trades in the account of the GC or ICSD held with the LC. The LC would be able to confirm such trade directly with the onshore CSD

11. Investor base

A large and diversified investor base ensures a strong and stable demand for a growing bond market. The investor base should include domestic and foreign participants from a variety of institutions – ranging from commercial banks to insurance companies, pension funds, hedge funds and mutual funds, as well as individual investors. A varied base will naturally create demand for a diverse range of time horizons, risk preferences and trading motives, which are vital for stimulating active trading and deep liquidity. In turn, those developments will enable the government, corporates and financials to execute funding strategies under a wide range of market conditions.

China has made significant progress broadening its foreign and domestic investor bases. However, there are still a limited number of pension funds, insurance companies and hedge funds active in the domestic market. An increase in participation of institutional investors expands the social safety net and makes markets more stable. In addition, restrictions on foreign firms' market participation continue to hinder the broader development of China's capital markets (although the recent opening of the CIBM to international asset managers has eased foreign investor access overall);



foreign firms would be able to provide necessary liquidity, market skills and investments if they were able to participate. With the advent of rules for CIBM and the easing of QFII and RQFII, this should change. In addition, the potential inclusion of Chinese domestic bonds in global bond indices will help increase in the weighting of Chinese bonds in debt portfolios around the world. Currently, less than two percent of Chinese domestic bonds are held by international investors.

Another point worth emphasising is that in the government bond market, most issuance is purchased in primary auctions by domestic banks, which warehouse these instruments to meet domestic liquidity requirements. As a result, investors cannot access or trade CGBs. Changing this dynamic would allow domestic banks to change their asset allocation strategy, moving away from government bonds and towards SME financing or corporate debt. This would allow other entrants such as insurance companies, pension funds and foreign investors to increase their exposure to less risky CGBs.²⁸

12. Green bonds

Green bonds have the same financial characteristics as standard bonds (senior unsecured, covered, ABS, etc.) with the added feature that their proceeds are earmarked for eligible green projects with explicit environmental benefits. Funds raised by Green bond issuances are allocated to environmental projects or activities explicitly including an environmental objective, such as renewable energy, energy efficiency, public transportation, efficient buildings, energy networks adaptation, waste and water management, preservation of biodiversity, etc.

Green bonds provide an attractive solution to one key challenge of current times: how to match issuers' needs for investments in clean energy with socially responsible investors' expectations regarding the use of the proceeds. The bond documentation clearly defines the use of proceeds, with a definition of projects or of the eligibility criteria to select projects or assets to be financed by the Green bond proceeds. One more important element is the regular reporting after issuance of the bond on the use of proceeds and actual environmental impact of the projects the funds have been invested in.

The Green bond market continues to grow rapidly: China is now a significant player and around 43 percent of 2016 Green bond Issuances were accounted for by China.²⁹

In December 2015, China released an announcement of the issuance of green financial bonds. Green projects were defined as a Green bond Endorsed Project Catalogue (Catalogue). The Catalogue includes the following six categories:

- Energy Saving
- Pollution Prevention and Control
- Resource Conservation and Recycling
- Clean Transportation

²⁸ASIFMA Paper: "China Bond Market Roadmap." ASIFMA, June 2014.

²⁹Ng, Eric . "Global green bond market tipped to reach US\$100bn in 2017, with China seen maintaining its lead." South China Morning Post, December 23, 2016. <http://www.scmp.com/business/companies/article/2056904/global-green-bond-market-tipped-reach-us100bn-2017-china-seen>.



- Clean Energy
- Ecological Protection and Climate Change Adaptation

The warm acceptance by China's capital market practitioners of socially-responsible concepts is a positive development for not only the domestic market but also global investors who can now participate to the financing of the energy transition in the second largest economy in the world. China's definitions of eligible projects are clearly documented with the Catalogue, and it is advisable to ensure that both international standards such as the ICMA-endorsed Green Bond Principle and Chinese Green Bond Guidelines continue to be closely aligned.

13. Municipal bond market

China's planned urbanisation initiative will require local governments to further enhance infrastructure. To overcome domestic financing challenges and allay concerns about shadow banking in local government lending or favourable treatment by regional banks, China has recently started to develop a municipal bond market.

A municipal bond is a long-term bond, issued directly by a local government (municipality) or local government-owned enterprise to finance an infrastructure project. Eligible projects may include construction or maintenance of roadways, bridges and other public institutions, such as schools and hospitals. The creation of such a market would allow a combination of domestic and foreign private capital to finance infrastructure projects, easing the dependence on local banks. In addition, a municipal bond market would increase the amount of longer term capital available for large-scale infrastructure development. Care should be taken not to simply replace regional bank lenders with those same regional banks buying those bonds at prices that do not reflect the true risk.

The potential advantages of municipal bond issuance are well documented and most clearly exemplified by the US municipal bond market. The low cost of capital raised in the municipal market is its most attractive feature. In a well-developed municipal market, issuers are able to keep interest rates low due to attractive tax incentives, which China would need to develop to drive investor appetite. Due to the tax incentives of municipal bonds, the market attracts a variety of participants – including underwriters and bond trustees – that compete, which keeps issuance costs low. The cost of issuing a municipal bond is further reduced by its long maturity, which allows local government to amortise the cost of construction over periods of time that approach the long lifespan of the infrastructure asset being built.³⁰

A number of Chinese local government bodies have issued bonds through their Local Government Financing Vehicles (LGFVs) in recent years, as Chinese regulatory authorities have sought to restrict the shadow banking markets and bring greater transparency to local government financing activities. The Chinese government turned a pilot municipal bond programme to a larger scale one in 2015, allowing 36 high-tier municipal governments to issue bonds directly.³¹ This is a welcome first step in the development of the Chinese municipal bond market. This is also important to attracting international investors. Our recent survey indicated that they favour central, local government and higher quality instruments.

³⁰ ASIFMA Paper: China Bond Market Roadmap." ASIFMA, June 2014.

³¹ 27 province or autonomous regions, four municipalities directly under central government and five designated cities



14. Corporate bonds

At USD 9.1 trillion,³² the Chinese bond market has become the third largest in the world. Issuance to date has generally been dominated by government and public sector bonds issued by government affiliated companies, which account for about 69 percent of the total bonds outstanding.³³ However, at the margin, corporate bond issuance has been growing and has the potential to grow at 40 percent of total outstanding volumes, over the next five years. At the end of 2005, corporate bonds accounted for just 7.2 percent of the total Chinese bond market.³⁴ It has grown to over 30 percent as of the end of 2016, in a market which has expanded ten-fold.

China's Domestic Bond Market Size Outstanding in Sector (Q3 2016)

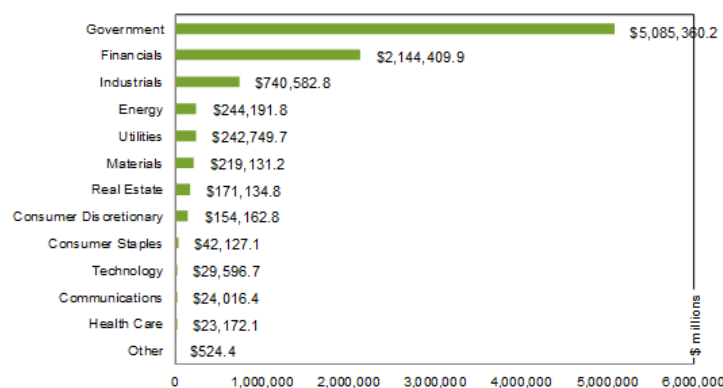


Figure 9: China's domestic bond market size outstanding in sector by millions of RMB in Q3 2016
Source: Bloomberg

The outstanding bond issues of government-affiliated policy banks, financial sector bonds (including those of the Big four commercial banks) and other banks/financial institutions total USD 2.14 trillion and account for 23.5 percent of the Chinese bond market, second only to government bonds.

Distribution of China Corporate Bond Market (May 2016)

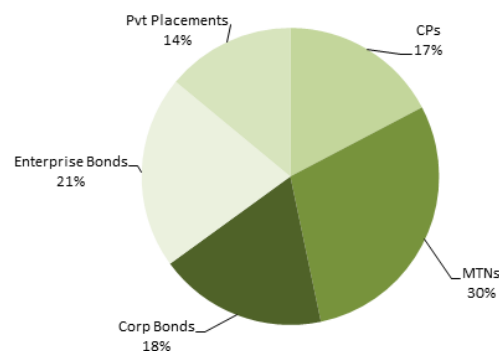


Figure 10: distribution by percent of China's Corporate Bond Market as of May 2016
Source: Deutsche Bank

³² Data: Bloomberg/Dealogic

³³ Data: Asiabondsonline/ADB

³⁴ Data: Asiabondsonline/ADB



The corporate bond market consists of the following types of instruments:

- Enterprise bonds typically those of SOEs, which are issued on the interbank bond market (accounting for 21 percent of the market)
- Commercial paper (17 percent) and MTNs (29 percent) issued by domestic companies and are regulated by NAFMII
- Corporate bonds (18 percent) which are issued by a whole range of private sector issuers and are listed on either the SSE or SZSE (regulated by the CSRC)

The following are the key sectors in the domestic corporate bond market, with significant volumes of outstanding bonds:

- Industrials: USD 740.6 billion
- Energy: USD 244.2 billion
- Utilities: USD 242.7 billion
- Materials: USD 219.1 billion
- Real Estate: USD 171.1 billion³⁵

The corporate bond market, which consists of several fast-growing sectors, is the key growth component of the Chinese bond market. This trend is expected to continue because of:

- Increasing depth and sophistication of China's capital markets, which will reduce the demand for bank lending
- Growth in NPLs, more stringent capital requirements, the growth of a "credit culture", and a more accurate assessment of risk versus reward
- Chinese authorities increasing their scrutiny of "shadow banking" activity, wealth management products and other unofficial banking channels

There are different classes of investors in each of these markets – the OTC interbank bond market largely comprises institutional investors while the exchange markets are aimed largely at retail investors. Some international investors, however, do access the domestic corporate bond market through the exchange markets as well.

Until recently, China's bond markets were generally restricted for foreign issuers, investors, and intermediaries. This has changed with the expansion of the QFII and RQFII schemes to allow foreign investors to invest in Chinese bonds and more recently, through the opening of the CIBM to eligible investors, all of which are discussed in the internationalisation section below.

An issue that merits urgent attention is the need to improve the strength of covenant packages in the Chinese domestic bond market. Generally speaking, domestic Chinese bonds typically do not have financial covenants regardless of their credit quality. Such covenants are standard in the international credit markets and are critical to providing confidence to all holders (both domestic and foreign bondholders) of Chinese domestic corporate paper. Introducing financial covenants will help improve investor protection, particularly in the context of the opening of the CIBM to foreign investors, referred to above. Corporate bond issuers should monitor all covenants in their bond

³⁵ Data: Bloomberg/Dealogic/ASIFMA as of (30 September, 2016)



indenture and credit facilities to ensure compliance and should disclose equally and promptly to all market participants any breaches of such covenants.

15. Securitisation

China's securitisation industry has seen explosive growth in recent years. In 2015 the volume of domestic ABS issuances in the interbank bond market and exchange markets grew to approximately RMB 602 billion³⁶ a nearly thirty-fold increase since 2013.

Securitisation was first introduced by the MOF, PBOC, and China Banking Regulatory Commission (CBRC) in China through the Credit Asset Securitisation (CAS) a pilot programme in 2005, but was suspended in 2008 following the onset of the global financial crisis amid concerns relating to securitised assets. The CAS framework, normally used by bank and non-bank financial institutions, was restarted in 2012, with an initial quota of RMB 50 billion. This has since been increased to RMB 500 billion, pursuant to an announcement by the State Council on 13 May 2015.

Despite the explosive growth of ABS issuance in China, existing laws permit only a limited class of investors to subscribe to ABS issuances adopting the SPT structure; this closed group mainly consists of domestic banks, insurance companies, securities companies and mutual funds.

When credit assets originated by a commercial bank are repackaged into ABS sold to other commercial banks on the interbank bond market there is no true transfer of risk. The situation is more akin to an exchange of risk within the banking industry, with no real offloading of risk to the capital markets.

Currently, non-financial corporations are mainly sponsoring securitisation via the Asset Backed Specific Plan (ABSP) regulated by the CSRC. There have been calls for a streamlined securitisation framework for all companies, which would remove the CAS/ABSP distinction. This would bring uniformity in addressing common legal risks, such as commingling, true sale and transfer of security, which are present across domestic securitisation offerings governed by Chinese law.

Several innovations have been seen in recent months in the Chinese securitisation markets – these include a programme of NPL securitisation and trust structure Asset Backed Notes (ABNs) issued by corporates in the interbank market; this is similar to the special purpose trust structure under the CAS framework. This is a welcome development since corporate issuers now have access to the more liquid interbank market. Also, for the first time in several years, collateralized loan obligation (CLO) issuance by banks (which merely moved corporate loan assets from one bank balance sheet to another) has accounted for a smaller share of ABS issuances in 2016, relative to other forms of securitisation. This is also a healthy development. On the other hand, existing regulations do not permit direct foreign investment into an onshore trust holding securitised assets. In addition, existing routes for foreign investors to access domestic ABS issuances are very restrictive.

The PBOC must promulgate a specific regulation to facilitate cross border foreign investments into an onshore trust holding securitised assets, this, subject to some basic requirements such as that the investment will be RMB-denominated and the investment scope and plan of the trust is mainly

³⁶ Data: WIND Financial



focused on asset securitisation. Denominating investments in RMB would not require the additional regulatory approval from State Administration of Foreign Exchange (SAFE), and it would provide a more direct and attractive route for direct foreign investment in domestic ABS issuances.³⁷

16. Efficient tax environments

As China's financial markets continue to develop, transactions across repo, futures, interest rate derivatives, and bond trading markets will become more inter-dependent, and the failure of tax rules to keep pace with the industry will create concerns for domestic and foreign-invested banks. For many years, China had two separate indirect tax systems, the Value Added Tax System (VAT), which applied to the goods sector, and Business Tax (BT), which applied to the services sector. In 2012, the Chinese government embarked upon extensive reforms to the indirect tax to fully replace BT with VAT. That shift was very helpful as the BT system was generally regarded as an inefficient turnover tax; it taxed businesses at each stage of the supply chain, with a VAT for services industries. The application of VAT for services industries was introduced through a pilot programme, which implemented the VAT rules for certain sectors progressively on a province-by-province basis before nationwide implementation on an industry-by-industry basis.

On 1 May 2016 the VAT pilot programme expanded to financial services and insurance, real estate and construction, and lifestyle services, completing its implementation. China's VAT system is unique by international standards in applying VAT to most financial services, which includes interest income.³⁸ While China's policymakers have shown promising signs of responding to industry concerns with the new VAT rules for the financial services sector, further enhancements are still needed to remove inefficiencies and to improve its international competitiveness. This would include:

- Ensuring that exports of financial services are not subject to output VAT, which is irrecoverable by the offshore recipient of the financial services
- Removing instances where VAT is borne as a real cost in B2B financial services transactions, such as where interest income received by the lender is subject to VAT but the corresponding input VAT credit for the business borrower is denied
- Replacing the current categories of VAT exemption with zero rating, so as to alleviate the VAT cost on inputs incurred by financial services providers
- Further clarifying the scope of special VAT rules which apply to interest, and to the trading of financial products, to provide greater certainty for investors, and to remove VAT liabilities where transactions occur offshore but with a Chinese counterparty

Recommendations for Fixed Income

1. Broaden the range of financial instruments that can be used to satisfy bank liquidity requirements, and reduce the absolute level required.
2. Adopt best practices based on global standards in information disclosure, for the prospectus/issuing document at the time of the new issue and on a continuing basis.
3. Strengthen the financial, legal and business due diligence process in the primary markets.
4. Streamline the bookbuilding process to provide flexibility in price determination similar to the

³⁷ "ASIFMA - Securitization in Asia 2015 ." ASIFMA, October 2015.

³⁸ Wolfers, Lachlan. "China: Country VAT Essentials Guide 2016." KPMG, 2016.



process used in international offerings.

5. Create a liquid classic repo framework for the repo market.
6. Allow banks, which are the major holders of bonds, to participate in the bond futures market.
7. Issue guidelines for offshore investors and other market participants on the Chinese domestic CDS market.
8. Formalise the central clearing of CDS and the designation of CCPs to mitigate counterparty risk.
9. Harmonise the different securitisation regimes to create a bigger, deeper and more liquid securitisation market.



F. Foreign Exchange

The RMB presence and influence has been growing in recent years as the Chinese economy expands and its external linkages increase. This has been achieved despite the fact that China has approached the internationalisation of the currency from the opposite direction to the perceived norm.

While there is no standard path to internationalisation, the process typically combines sequential and incremental steps involving, firstly, the exchange rate regime by allowing the rate to be determined increasingly by the market, and then convertibility of the capital and current account prior to the full liberalisation of the capital account to ensure the liquidity of, and confidence, in the currency.

In the case of China, the internalisation has taken a different trajectory with the increased international usage of the currency taking place without its full transferability and convertibility in a regime where rates are typically managed.

1. Overview

Over the past decade China has implemented a number of enhancements to its currency regime. In 2005, the PBOC took the first important step when it announced a managed floating exchange rate system in which the daily fix for the exchange rate was to be determined by reference to a basket of currencies, instead of only the USD. However, no details were provided of the composition of the basket.

China has also relaxed the trading band within which the RMB is allowed to trade. In 2007 it was increased from 0.3 to 0.5 percent, and then again to one percent in April 2012 with the most recent increase to two percent in March 2014. By widening the trading band, market participants should have a greater influence on the currency, making it more attractive for investors and promoting its broader usage for settlement of cross-border trade. However, as history has shown, this is not always the case given the PBOC's objective of keeping the exchange rate within a tightly controlled band; hence, the market's influence may not be fully captured.

The PBOC announced further changes in August 2015 when the daily fix was to be based on the previous day's market close rather than being determined by the central bank. Then in December 2015, the CFETS unveiled the CFETS RMB Index to be used to assess exchange rate movements. This was an attempt to shift the market's focus from the RMB against the USD exchange rate to the RMB's performance against a basket of currencies used by its trading partners, reflecting the perspective that the exchange rate should capture the international trade flows of China. The original Index consisted of 13 currencies with weightings based mainly on a trade-weighted average to take into account re-exports, and included all of the world's major reserve currencies, which combined account for more than 80 percent of the basket. The USD had the largest weighting with 26.4 percent, while the weightings of the Euro and the Yen components were 21.4 percent and 14.7 percent respectively. In December 2016, the CFETS Index was refined with 11 more currencies added to the basket, resulting in reduced weightings for the USD, the Euro and the Yen.



CFETS RMB Index

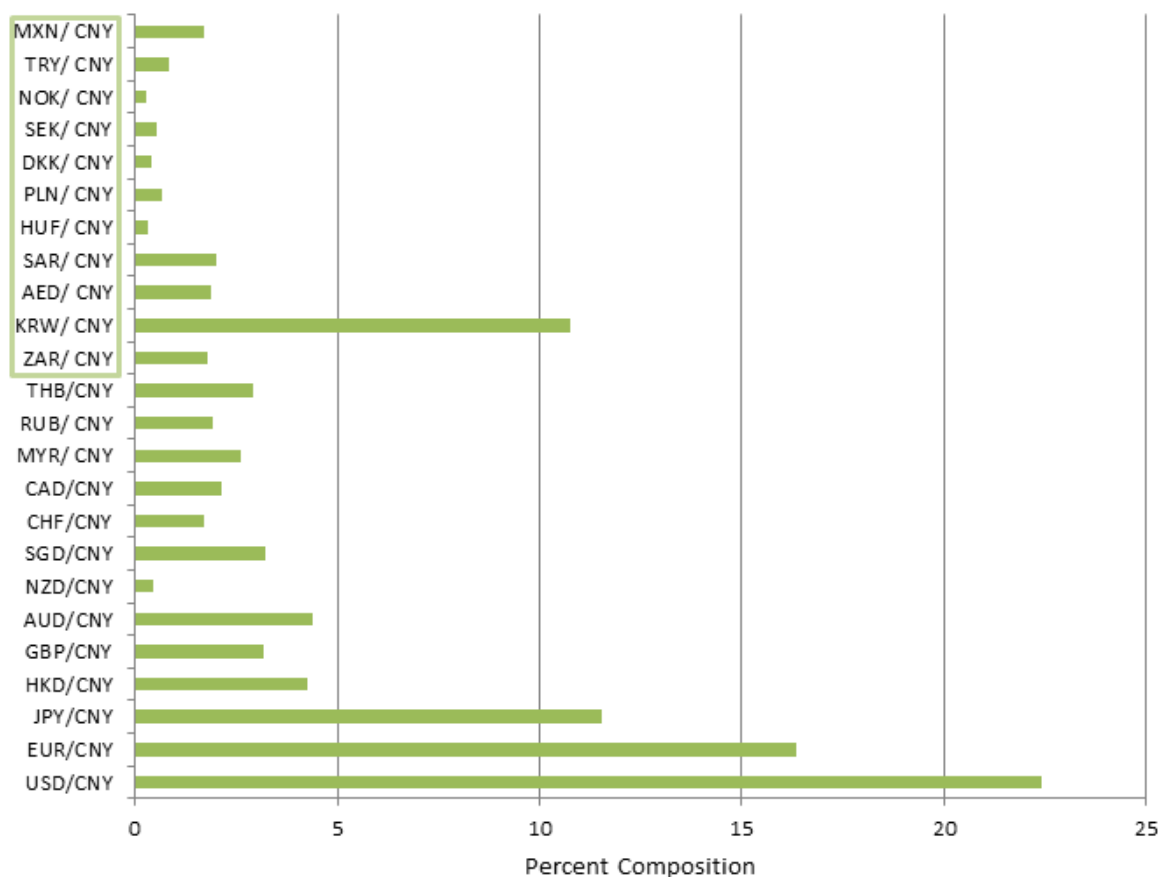


Figure 11: Percentage composition of the CFETS RMB Index (currencies added in Dec 2016 are in the box)
Source: CFETS

1a. Internationalising the RMB as payment currency

Another significant development in China's currency policy has been the promotion of the external use of RMB to settle current account transactions. Cross-border trade settlement was launched on a trial basis in July 2009. It was initially restricted to selected firms in five regions in Mainland China for trading with Hong Kong SAR, Macao SAR and ASEAN countries. The trial scheme ended in 2012 when all Mainland firms and current account transactions became eligible for invoicing and settlement in RMB. After having stabilised at the fourth or fifth place for most of 2015 and 2016, in October 2016, the RMB was down to the sixth most active currency for global payments by value with a share of 1.67 percent (up from 1.39 percent in January 2014) and was behind the Canadian Dollar in fifth place with a share of 1.82 percent.

RMB's Share as an International Payment Currency (2014–2016)

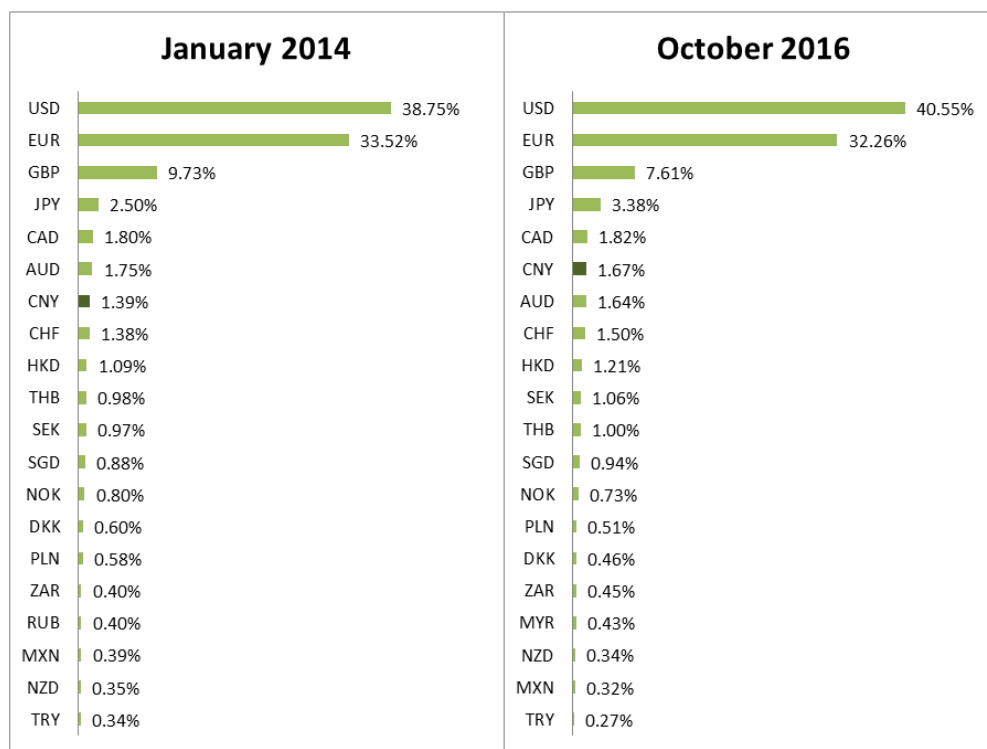


Figure 12: SWIFT's customer initiated and institutional payment messages exchanged on SWIFT organised by value on Jan 2014 and Oct 2016
Source: SWIFT

1b. RMB trading

Despite the ongoing reforms, China's onshore RMB (CNY) FX market remains highly regulated. Access to the wholesale market is granted only to domestic banks, SOE's and domestic subsidiaries of foreign banks.

The CNY market is small in relation to China's GDP and its economic links with the rest of the world. In April 2015, China's FX derivative market was only 0.2 percent of GDP compared to an average figure for emerging markets of 12 percent and 24 percent for developed markets. Furthermore, according to the 2016 Bank for International Settlements (BIS) Triennial Survey China has just a 1.1 percent share (up from 0.7 percent in 2013) of the global over-the-counter FX turnover.

Notwithstanding the above, the RMB (which includes the offshore currency (CNH)) became the most actively traded emerging market currency and the world's eighth most actively traded currency. The 2016 BIS Triennial Survey shows that the average daily turnover increased by 69 percent to USD 202 billion in the three years to 2016 of which approximately 95 percent is against the USD.

1c. RMB as Special Drawing Rights (SDR) component currency

The inclusion of RMB, on 1 October 2016, in the IMF's Special Drawing Rights (SDR) basket of currencies with a weighting of 10.92 percent, the third largest weighting, was recognition on the world stage of China's efforts to internationalise its currency and broaden onshore and offshore



access to its capital markets. It is hoped that the RMB's inclusion in the SDR will increase investor appetite for RMB-denominated assets and encourage a wider use of RMB in cross-border transactions. However, it is not expected that there will be any meaningful increase in the immediate term given the expectation that the currency will continue to depreciate. In addition there will be reluctance to invest if it is illiquid and if FX risk cannot either be hedged or exited easily.

Further currency liberalisation in the short to medium term is unlikely given that the pressure of capital outflows continues to be high following the result of the US general election as well as recent and future expected US monetary policy. As a result, the Chinese authorities have recently further tightened controls around currency and cross-border transactions as the government focuses on economic and political stability.

However, as discussed later in the paper (see Section G.4 close-out netting section and QCCP section), there are steps that can be taken to establish a transparent legal regime to assure market participants that they will be treated in accordance with international standards.

2. Outlook for RMB in the SDR basket

The RMB has joined the USD, the Euro, the Yen and the GBP as an SDR basket member. In the decades to come, its share is expected to gradually increase. It will be boosted by the rising importance of China in the global economy and the growing reflection of its role in financial markets.

The weight of an SDR currency in the basket is based on a formula. It has the form of an arithmetic average of two indicators, one representing the real economy and one reflecting financial markets. The former equals the share of the country issuing the currency in current account receipts among all SDR-issuing economic areas. The latter corresponds to an arithmetic average of three sub-indicators. The first equals a currency's share in reserve assets; the second in foreign exchange market turnover; and the third its share in the sum of international banking liabilities and international debt securities denominated in the currency.

China's importance according to all of the above criteria is bound to increase from current levels. Upside for its share in current account receipts is more limited given the country's already strong position. On the other hand, China's role in global financial markets is lagging its economic achievements and is bound to expand more significantly. Consequently, we estimate that at the next IMF review, likely in 2021, the weight of the RMB in the SDR basket will increase to about 15 percent. The currency's increasing weight will not stop there, and it should eventually approach the role played by the Euro and the USD.

The current status of the RMB's role as an SDR currency, and – more importantly - outlook for its expansion, will be a crucial determinant of its role as an international reserve currency. This is because global central banks have a propensity to allocate their reserves primarily to SDR currencies. In fact, there is a strong correlation between a currency's weight in the SDR basket and its share in global reserve asset allocation.

It is estimated that currently about 1.5 percent of global FX reserves are allocated to the RMB. Based on conversations with central bankers as well as historical trends, we expect the ratio to rise to five



percent in five years' time. This would correspond to seven percent of all non-Chinese reserves. In addition, sovereign wealth funds and supra-national agencies will also reallocate part of their assets to the RMB. In USD terms, we estimate that about USD 125 billion p.a. will be invested in the Chinese currency during the next five years. The process will support the RMB's value and will be a key driver of its internationalisation.

3. Electronic trading

Banks and customers prefer electronic execution due to the efficiencies and cost savings that it brings to execution and transaction processing through higher straight-through processing and much reduced error rates.

The CFETS is the electronic platform for the trading of interbank FX in China. The interbank FX market works on a membership basis and its participants include FX-designated banks, qualified non-banking financial institutions and non-financial enterprises.

CFETS offers members the ability to execute electronically either on a named basis or via a Central Limit Order Book (CLOB) on an anonymous basis. However, because settlement of the transaction is directly with CFETS, the costs of trading have made it less attractive and so price discovery is relatively poor. The trading of FX swaps and options is done on a bilateral basis but all trades have to be registered on the CFETS platform.

NEX Group plc, formerly ICAP plc, signed a contract with CFETS in June 2016 to deliver its electronic NEX Markets platform as the next generation trading system for the FX and fixed income businesses. This new system should enhance CFETS's capability to offer CLOB and disclosed trading models for FX spot, forwards and swaps.

Banks are able to offer their onshore customers' electronic execution via single dealer platforms but the onerous documentation requirements to evidence the underlying real economy transaction has limited the efficiency of this method of execution. Consequently, customers execute their FX trades with dealers via the phone. There have been a number of developments to simplify the documentation requirements, the latest of which were announced by the SAFE in September 2016 and took effect in November 2016. This permits banks to refer to a customer's electronic documents when settling FX transactions.

4. Product developments

The gradual internationalisation of the RMB has resulted in its growing significance as a settlement currency. One component in achieving this has been the introduction of the offshore pool of deliverable RMB, or the CNH market, in 2010 when banks located in Hong Kong were able to settle RMB with one another. Since 2010, the CNH market has grown exponentially with daily turnover around USD 27.7 billion for spot and USD 19.7 billion for forwards in 2016.³⁹ Whilst turnover in

³⁹ "Triennial Central Bank Survey Global foreign exchange market turnover in 2016." Bank for International Settlements, December 2016. <http://www.bis.org/publ/rpfx16fxt.pdf>.



deliverable CNH has grown, there has been a corresponding reduction in the daily turnover of CNY NDF, down from USD 17.1 billion in 2013⁴⁰ to USD 10.4 billion in 2016.

Prior to the development of the CNH market, the only means available for offshore market participants to hedge their RMB exposure was via the NDF Market. The fact that the daily fix for the NDF is the same as the morning fix published by the PBOC means that market participants are exposed when the CNY/CNH rates diverge. Despite its contraction, the NDF market continues to be used by corporates that are either concerned about the recent bouts of illiquidity or are yet to develop the infrastructure to enable them to physically settle RMB, or it is used by market participants for speculation. However, the popularity of the CNH market means that it is likely the NDF market will continue to become less liquid and ultimately disappear over the next five years.

In April 2011, SAFE introduced new rules that permitted locally based banks, financial institutions and corporates to trade vanilla European FX options. At the time, although corporates were only permitted to buy options, it was seen as another step in the internationalisation of the currency and growing the FX market. However, the market did not experience the growth in turnover that it was expecting due in part to the costs incurred in buying options and the lack of sophistication of the users.

The restriction on corporates was lifted in August 2014 when they became able to both buy and sell FX options. This gave corporates the ability to trade simple strategies and the opportunity to reduce their hedging costs.

More recently, the PBOC and SAFE have allowed central banks to trade FX derivatives directly in the interbank market, which was seen as a key step in encouraging investment in the interbank bond market. The involvement of central banks was further encouraged when they were permitted to negotiate ISDA Master Agreements with their onshore counterparties for FX derivatives. Up until this time, counterparties trading onshore could only negotiate the domestic Master Agreement issued by the NAFMII. However, exactly what these changes will mean remains to be seen given that the preferred hedging instruments for long-term bond holders are either long-dated forwards or cross-currency swaps, neither of which is covered under this change.

Whilst there have clearly been positive developments in the FX market since the deliverable CNH currency was introduced back in 2010, there continue to be restrictions that limit the size of the onshore market:

- Access to the market is limited, which means that activity is very directional and there are no natural hedges for liquidity providers
- The lack of close-out netting legislation is more of a limiting factor on the size of the market than liquidity
- The lack of certainty regarding final and irrevocable settlement will continue to limit risk appetite and trading as volumes increase and the currency usage grows
- There is uncertainty as to which long-term institutional investors investing in the CIBM are permitted to hedge their FX exposures

⁴⁰ "Triennial Central Bank Survey Global foreign exchange market turnover in 2013." Bank for International Settlements, February 2014. <http://www.bis.org/publ/rpfx13fxt.pdf>.



- There is a need to adopt standard international account documentation across all market participants
- There is no PVP risk mitigation infrastructure for the protection from loss of principal. This risk mitigation is important to investors and is available in developed currencies including the most active cross currencies traded with RMB

Furthermore, the anticipated role that the Shanghai FTZ would play in the market has not materialised.

End users should not be discouraged from hedging their FX exposures, but whilst hedging costs remain high this dis-incentivises prudent risk management practices. Introducing simple exotic options, such as barrier and digital options, into the available product suite could provide an incentive. Barrier options were created to provide the hedge of an option but at a lower premium than a conventional vanilla option, thereby reducing the cost and increasing the leverage.

5. Cost of trading CNY

At present, the onshore markets, with the exception of spot which is highly liquid, are inefficient and costly, making them less attractive to those market participants permitted to trade in them. These inefficiencies arise primarily from the PBOC's intervention in the market to maintain stability and prevent speculation.

The opening up of the option market in 2015 did not result in the expected increase in activity hence the FX derivative market remains disproportionately small relative to the size of the economy and compared to other emerging and developed market economies. A contributing factor to the slow growth is a lack of familiarity of the onshore participants with the products. However, another cause is the restriction of access to the FX market. In the offshore market, there are numerous non-bank participants that trade both sides of the market, thereby enabling banks to offset the vega risk from selling options and avoid the costs associated with risk warehousing. In the onshore market, where trading sentiment is directional, non-bank participants do not have access to the market. The resulting build-up of risk by the banks incurs costs that need to be recovered through wider spreads which dampens the demand from end users.

Additionally, the current arrangements may negatively impact the bilateral trading and settlement limits in the RMB. While there are alternatives available to the market to increase bilateral trading and settlement limits, these alternatives are not being deployed fully. Absent the implementation of such solutions, such as PVP and DvP settlement, the cost of trading CNY and CNY-denominated assets incorporates the costs of these risks. Additionally, the lack of risk protection of principal in the exchange of currencies without PVP may deter investors.

Further action by the PBOC following its two percent devaluation of the RMB on 11 August 2015, has resulted in higher costs for end users. As part of an initiative to reduce onshore speculation in the FX market, the PBOC required dealers to place a USD-denominated deposit at the Central Bank at zero percent interest for one year. The size of the deposit is calculated based on a percentage of the notional value of all outstanding FX contracts where their client is long USD. The percentage is set at 20 percent for forwards and swaps and 10 percent for options. Since its introduction the



requirement has been reinforced through more frequent calculations and widening of the net of impacted banks. As a result, the costs of holding the reserve at the PBOC are incorporated in the pricing, and may have had the unintended consequence of pushing market participants to trade options.

Whilst the priority of the PBOC remains the stability of the currency the role of the FX market will continue to be suboptimal and market participants will carry more FX risk to avoid the inflated market costs. Deep and liquid FX markets that provide good price discovery are an essential component for investors looking to invest in the onshore equity and debt markets.

6. Financial transaction taxes (FTTs)

FTTs are more closely associated with securities than they are with foreign exchange. One of the first proponents of a securities transaction tax (STT) was John Maynard Keynes when he proposed, in the wake of the Great Depression in 1936, that a tax should be levied on Wall Street to reduce excessive speculation. Since then there have been a number of instances of STTs being levied on the secondary trading of equities.

At the G20 meeting in Pittsburgh in 2009, the IMF was tasked with investigating a range of options available for governments to impose on the financial sector in order to make a fair and substantial contribution toward paying for the interventions required to repair the banking system. The IMF considered the use of FTTs but ultimately favoured the use of a financial-activities tax levied on the sum of a financial institution's profits and wages.

The action of the 10 Euro-zone countries to implement an FTT on stock, bonds and derivatives transactions runs counter to the general downward trend in STTs over the past two decades as governments seek to lower capital costs and boost the competitiveness of their domestic markets in the face of globalisation. This is reflected in the fact that the European tax was first proposed in 2011, and agreement has not yet been reached amongst worries of the impact of any such tax on capital market funding of corporates and sovereigns as well as the economy as a whole.

A Currency Transaction Tax (CTT), on the other hand, used as a fiscal control over foreign exchange in place of administrative or regulatory measures is much less widespread; currently only Brazil levies a CTT. The inevitable consequence of the imposition of a CTT is an increase in transaction costs typically via the widening of the bid-offer spread, an increase in fees or both. This increase in cost renders some trades unprofitable and so reduces trade volume and inevitably liquidity, which in turn reduces price discovery.

A transaction tax on liquid products, such as foreign exchange, tends to be only a very small fraction of the overall price. However, even a very small CTT can represent a significant proportional increase in transaction costs on liquid products, which is why their trading volume is most sensitive to the imposition of a tax. CTT would represent a much bigger burden on frequently-traded products than on those that are held for longer, thereby impacting real-economy end-users and investors far more than market speculators.



Whilst the introduction of a CTT is designed to drive speculative traders out of the market by eliminating the opportunity to generate short-term profits, it is also highly likely to reduce the activity of real economy end-users using the market to hedge their foreign exchange risks because of the increased transaction costs. This behaviour results in under-hedging and a build-up of market risk in a sector of the market ill-suited to being exposed to financial risk.

A further consequence of the introduction of a CTT is the increase in costs incurred by international investors looking to invest in the CIBM and equity markets. If this money is withdrawn it would be necessary to significantly increase interest rates in order for the onshore capital markets to still be attractive.

In response to the proposed European FTT, Oliver Wyman⁴¹ calculated that the cost of FX forwards, swaps and options would increase by between three and seven times as a direct consequence of the tax, and that the cost for the most liquid products, such as swaps with a maturity of less than one week, would increase by up to 18 times. For example, the report calculates that the cost of a EUR 25 million one-week EURUSD swap, subject to a tax rate of 0.01 percent on notional, would increase from EUR 279 to EUR 2,779.

Further action by the PBOC to increase the cost of transacting FX would be inappropriate at this point in time given the potential risk that it could trigger greater capital outflows and the impact that it will have on corporate end-users and the financial investor community. Given the immediate priority is the stability of the currency, the authorities should look to further strengthen the existing controls that are in place to eliminate market speculation whilst there continues to be downward pressure of the RMB.

Recommendations for FX

1. Encourage greater competition in electronic execution by allowing other platforms to collaborate or to compete with CFETS thereby improving efficiency and driving down the costs of execution.
2. Introduce new products to provide end users with a wider opportunity to hedge their currency exposures at a lower cost.
3. Refrain from introducing an FTT as it will harm liquidity and undermine other positive market reforms.

⁴¹ Wagner, Michael. "Proposed EU Commission Financial Transaction Tax - Impact Analysis of Foreign Exchange Markets." Oliver Wyman, January 2012. <http://www.oliverwyman.com/our-expertise/insights/2012/jan/proposed-eu-commission-financial-transaction-tax---impact-analys.html>.



G. Laws and Regulations

China should consider adopting regulations that are consistent with internationally accepted standards. If policymakers can deliver an appropriate level of similarity, comparability and predictability in regulatory outcomes with other jurisdictions it will allow financial institutions, both domestic and international, to operate and offer services cross-border without unnecessary impediments or complexity. Companies, investors and even retail customers will be able to access services safely and efficiently without risks to financial stability. This will only benefit China's economy overall.

China will need to overcome considerable legal, economic and political constraints to achieve this consistency but the results will bring tremendous benefits for institutions and reduce the economic costs to financial instability, end-users, financial institutions, and the wider economy. It is also important that there be a robust system for the implementation of regulations in order to increase the efficiency of the financial system, promote domestic economic growth and increase overall prosperity. What is needed is a balance between achieving positive outcomes of greater financial stability and allowing necessary levels of supervisory discretion and sensible local differences. China does not need absolute consistency with other jurisdictions, but merely sufficient consistency, with global legal, regulatory, and commercial standards that are generally implemented in other major jurisdictions.

1. Regulatory processes

ASIFMA's global investors' survey confirms that regulatory transparency and consistency, market consultation process, sufficient notification of new rules and time for public comment and implementation are vital to develop well-functioning financial markets and key to attracting international investors. A large number of regulatory and quasi-regulatory bodies govern the financial services sector in China (e.g. PBOC, SAFE, MOF, State Administration of Taxation (SAT), NDRC, CSRC, CBRC, China Insurance Regulatory Commission (CIRC), and NAFMII), and each has its own priorities and processes.

Across these regulators, government bodies, and standard-setting agencies, there is no consistent process for engaging with or notifying the industry about regulatory changes. This means that regulatory changes across these institutions can be inconsistent, causing the approval processes for new products or licenses to suffer from the absence of a coordinated regulatory approach. Rules are often unclear and reasons for denial or approval are not widely disclosed. In some cases, the rules themselves are not readily available publicly. At times, it is unclear which regulator's approval is required and regulators themselves will sometimes disagree among themselves about required approval processes or procedures. Increasing both coordination among China's regulatory agencies and transparency of their processes will reduce uncertainty and foster both domestic and foreign investors' confidence in the market.⁴²

⁴² "ASIFMA Paper: China Bond Market Roadmap." ASIFMA, June 2014.



It would be helpful if China's legislature and regulatory bodies publicly consult on their proposed rules and regulations so that areas, topics, and items of potential concerns can be identified to ensure the successful implementation of these regulations when they are issued.

2. Corporate governance

The topic of corporate governance is complex but there are many reasons to expect good corporate governance from Chinese corporates to benefit shareholders, and by extension to benefit broader society through economic growth, institutional stability, and social development. A Harvard Law School study in 2016 found well-governed companies will typically have a higher market valuation. Improving corporate governance, especially in developing markets, typically increases inflows of capital.⁴³ China's stock markets in particular have been vulnerable to concerns about weak corporate governance, limited transparency, and weak auditing standards and accounting practices. Continued efforts toward improving corporate governance at Chinese public companies will improve investor confidence, lift valuations, and help reduce the cost of capital. This is key to attracting foreign investors, according to our global investor's survey.

3. Bankruptcy, insolvency and resolution regimes

Anticipating larger bankruptcy caseloads, a number of provincial-level courts and governments have announced plans for measures to help bankruptcy processes move more smoothly, efficiently and transparently. Although their approaches vary, measures being taken include simplifying the proceedings in minor and uncontested cases, establishing a special bankruptcy division within the courts, and setting up information-sharing mechanisms. It remains to be seen how these measures will be implemented in practice, and what their impact will be on bankruptcy and reorganisation practices in China.⁴⁴

Moreover, China has not yet implemented a resolution and recovery regime for financial institutions that is consistent with the Financial Stability Board's Key Attributes of Effective Resolution Regimes for Financial Institutions (Key Attributes), which provides global guidance on how to resolve or recover assets related to a financial institution. However, the CBRC has taken a positive first step by drafting the Financial Institution Resolution and Bankruptcy Guidelines. This reform, along with the recent introduction of a deposit insurance guarantee scheme, would provide additional clarity about investors' place in the credit structure of Chinese banks, which has been unclear due to the implicit government guarantee. China is home to four globally systemically important banks (G-SIBs) and has several large domestic banks with growing international footprints and global aspirations. If China's resolution regime does not fully reflect globally agreed standards, it may potentially affect international banks. Furthermore, implementing a resolution and recovery regime compliant with the Key Attributes would force investors to consider the credit quality of Chinese banks – e.g. by pricing the bonds of the four G-SIBs differently from those of a small provincial lender – when purchasing their bonds or other investment products.

⁴³ "Why Corporate Governance." International Finance Centre World Banking Group. 2013.
http://www.ifc.org/wps/wcm/connect/topics_ext_content/ifc_external_corporate_site/corporate_governance/overview/why_corporate_governance.

⁴⁴ Ji, Nuo. "2016 Insolvency and Corporate Reorganisation Report: China." IFLR, April 28, 2016.
<http://www.iflr.com/Article/3549970/2016-Insolvency-and-Corporate-Reorganisation-Report-China.html>.



4. Creditors rights and close-out netting

As repo and other derivatives markets grow, Chinese regulators should consider strengthening rules governing creditors' rights. These reforms are essential for market participants to gain confidence in the enforceability of transactions and contracts, and are of particular importance for derivatives transactions and contracts, which are typically traded under master agreements and secured by collateral.

The enforceability of close-out netting, an established risk-management practice in all advanced financial markets, is a fundamental requirement for efficient markets. China is currently the only major global economy that is not perceived as having enforceable close-out netting protection. Close-out netting enables all exposures to be recognised on a net rather than a gross basis, resulting in improved credit-limit utilisation. It also facilitates the taking of collateral to offset exposures and reduces the level of reserves required under the regulatory capital requirements. Furthermore, these protections allow market participants to increase their bilateral trading and settlement limits.

The lack of certainty regarding enforceability in China means that a bank's exposure to a Chinese counterparty is treated on a gross basis for regulatory capital purposes. Post-crisis regulatory reforms assign much higher capital requirements for non-netted trades, which sharply increases transaction costs. This also makes it extremely difficult for China to develop liquid derivatives and repo markets, both of which are required if their capital markets are to become deep, liquid and accessible to global investors.

For close-out netting to be enforceable it needs to be legally recognised in the jurisdiction of incorporation of the defaulting party, and the insolvency legislation should permit close-out netting in the event of a default or termination event under a master agreement in accordance with the terms of the agreement.

In China there have always been uncertainties surrounding the enforceability of close-out netting. Although the Supreme People's Court interpretation of the PRC Enterprise Bankruptcy Law (II) (Bankruptcy Law) issued in September 2013 clarified that a non-defaulting party is entitled to calculate the exposure of all the terminated transactions on a net basis within the preview of bankruptcy set-off rules, it is not clear whether the non-defaulting party would be able to terminate all transactions once liquidation proceedings have commenced. The current view is that a non-defaulting party's ability to terminate all outstanding derivative contracts under a master agreement is subject to the administrator's moratorium power under the Bankruptcy Law.

In order to attempt to safeguard the right to close-out, it would be necessary to apply the modified AET provision in the master agreement. The recent issuance of the Supreme Court Notice clarifies that the courts would review a bankruptcy petition to ensure it conforms to certain statutory requirements prior to registering it. This would appear to prevent a premature triggering of the termination under such a master agreement. However, the validity of this provision has not been tested under the Bankruptcy Law.

There are several netting initiatives that are understood to be in progress in China:



- A new Futures Law is being drafted and it is hoped that it will include netting provisions applicable to OTC interest rate and FX products. However, the timing of the conclusion of its drafting and implementation is uncertain.
- The CBRC is drafting Financial Institution Resolution and Bankruptcy Guidelines.

5. Use of collateral

It is currently not common practice for financial counterparties to exchange collateral to cover domestic OTC derivative exposures. In addition, the Securities Law does not fully support the exchange of variation margin used in the international markets. Consequently, Chinese financial institutions lack the infrastructure to be able to undertake daily mark-to-market calculations and to call collateral from counterparties. Furthermore, third party custodians used to hold initial margin on behalf of the posting counterparty do not currently exist in China. Pending a full liberalisation for foreign investors to hold onshore debt securities under Chinese regulations, there remain certain practical difficulties for a foreign institution to use onshore debt securities as eligible collateral and credit enhancement for its ISDA transactions.

The absence of clear netting rules, a legal framework supporting collateral enforceability and the lack of technical and market infrastructure to support the exchange of collateral is expected to have negative consequences for onshore liquidity following the implementation of the G20 post-crisis regulatory agenda, specifically the requirement to exchange margin on non-centrally cleared OTC derivatives.⁴⁵ Collectively, the absence of these institutional pillars that individually and jointly contribute to supporting the smooth and efficient functioning of all financial markets increases the cost of hedging and reduce the efficiency of derivatives as risk mitigation tools. The first deadline to exchange initial and variation under the margin regime on 1 September 2016, applied to a limited number of international Phase 1 entities with an uncleared OTC derivatives exposure greater than USD three trillion.

Whilst Chinese onshore entities did not fall within the scope of the September deadline, the requirement to collect and post variation margin with any "covered entity" from 1 March 2017 will have an impact on Chinese entities. In particular, the rules govern exposures with covered entities in non-netting jurisdictions, such as China. It is generally expected that the ability of a material number of international banks to trade with entities in these jurisdictions will be impacted.

Recommendations for Laws and Regulations

1. Increase regulatory transparency and consistency by a more open market consultation process, providing sufficient notifications of new rules and allowing public comments.
2. Improve transparency and reliability of auditing and accounting standards to increase confidence by international investors in China's corporate governance.
3. Improve the corporate resolution and bankruptcy process to allow investors to predict the impact of defaults by, among other things, ensuring the enforceability of all investor's direct security interest, if any, in a fair, transparent and clear manner in a restructuring or bankruptcy.
4. Implement a resolution and recovery regime for financial institutions that is consistent with the

⁴⁵ "Basel Committee on Banking Supervision Board of the International Organization of Securities Commissions Margin requirements for non-centrally cleared derivatives." Bank for International Settlements, March 2015. <http://www.bis.org/bcbs/publ/d317.pdf>.



Financial Stability Board's Key Attributes of Effective Resolution Regimes for Financial Institutions.

5. Incorporate clearly and unambiguously the enforceability of close-out netting in statute, reflecting internationally accepted practices.
6. Amend the Securities Law to support the exchange of variation margin used in the international markets and reflecting internationally agreed standards.



H. Market Infrastructure

Infrastructure is important and needs to ensure connectivity with the rest of the world. There has been progress made especially with the introduction of the Cross-border Interbank Payment System (CIPS), which allows for payment interface with SWIFT.

1. Centralised clearing of OTC derivatives

The SHCH clears and settles trades, as well as provides registration and depository services for spot and derivative transactions in the interbank market. The centralised clearing service, which includes client clearing, covers certain CNY-denominated interest-rate swaps and USD/CNY FX forwards, swaps and options. Whilst the SHCH is currently the only CCP globally that offers the clearing of physically-settled forwards, swaps and options, Hong Kong Exchange (HKEX) and Clearing Limited launched its USD/CNH cross currency clearing service in August 2016 through its subsidiary, OTC Clearing Hong Kong Limited.

Despite the concerns that exist around the lack of close-out netting in China, the rules of the FX Clearing Service provide for settlement finality and close-out netting. However for as long as this is not supported by Chinese law, such rulebook language is of limited use. In addition to the requirement that clearing members are required to post-initial and variation margin, the SHCH also operates a guarantee fund and a reserve fund as part of its default management resources and each clearing member is required to contribute to the guarantee fund. Currently, the only eligible collateral for margin is cash.

At present only the clearing of CNY interest rate swaps is mandatory and there is currently no indication from the SHCH or China's regulators that the mandatory regime will be extended to the FX products. The introduction of mandatory clearing has brought China in line with its G20 commitments and represents a significant step in developing its derivatives market. However, it does create other issues with regard to the recognition of the SHCH as a qualified CCP (QCCP) in third-country jurisdictions. While PBOC has determined SHCH is a QCCP for Chinese capital purposes, third-country market participants are not always allowed by their own regulators to rely on such determination.

During a default, the SHCH is able to close-out all outstanding positions of a defaulting member and settle on a net basis.⁴⁶ In addition, the SHCH has implemented rules that provide for automatic early termination (AET).⁴⁷ However, as stated above, given an administrator's moratorium power under the Bankruptcy Law and the fact that the validity of the AET provision has not been tested under the Bankruptcy Law, there is a risk to clearing members in the event that exposures of an insolvent clearing member are not terminated by the time a court accepts the bankruptcy petition.

The SHCH's clearing rules and clearing agreement state that settlement for cleared products is irrevocable upon completion. However, China lacks statutory provisions for settlement finality on

⁴⁶ It should be noted that the SHCH's rules lack the ability for a clearing member to close-out against the CCP in the event of the SHCH's default.

⁴⁷ At the time of writing, we note that SHCH has adopted modified AET, but the membership agreement published on its website is an older version and still using the non- modified AET.



transactions with a CCP as the Bankruptcy Law supersedes the clearing rules. In its Principles 1 and 8, the Principles for Financial Market Infrastructure specifically mandate well-founded, clear, transparent, and enforceable legal basis and clear and certain final settlement, respectively. Consequently, if a clearing member becomes insolvent, a Chinese bankruptcy administrator can recover settlement funds paid by that clearing member to the SHCH if the facts show that the clearing member preferred SHCH over other creditors. In addition and for the same reason, the administrator also has the ability to revoke the application by the SHCH of an insolvent member's guarantee fund contributions, thereby creating potential liabilities for the non-insolvent clearing members.

The ability of a clearing house to use collateral posted by its clearing members is essential to its risk management practices. A clearing house typically takes a security interest in collateral so that its claim in respect of the collateral can benefit from a legally recognised priority. Alternatively, the title to the collateral can be transferred from the clearing member to the clearing house outright.

However, the SHCH does not adopt the normally recognised approach. Instead, under the clearing rules, a clearing member is required to transfer cash into a margin account opened by SHCH with a commercial bank. Cash margin collected from all members are then all deposited into the same margin account. Neither the clearing member nor SHCH creates a security interest over cash in the margin account in a way that is recognised by the China's Property Law or Security Law. That said, we note that such an approach has also been used in the Chinese futures market. The Chinese futures market has been established for more than 20 years, during which time the validity of such cash collateral arrangement in the futures market has not been challenged or invalidated by the Chinese courts.

There is currently no legal recognition of the bankruptcy remoteness of collateral posted under Central Clearing, which means that in case of an insolvency of the CCP, such collateral could become an integral part of the CCP's bankruptcy estate.

There is also a potential concern if the SHCH were to call for clearing members' replenishment payment to cover shortfall in the guarantee fund that such payments could lead to unlimited liabilities. In addition, in the event of multiple members' defaults, there is the concern that such member replenishment requirements could lead to unlimited liability.

2. QCCP status of the SHCH

In the aftermath of the global financial crisis of 2008, the G20 derivatives regulations created significant extraterritorial requirements. In particular, there is a need for CCPs under the rules of those jurisdictions operating mandatory clearing regimes to be recognised as a QCCP. Despite the PBOC recognizing the SHCH as a QCCP, failure to be recognised by other jurisdictions could limit the participation of entities from those jurisdictions in the Chinese OTC derivatives market. As at 30 June 2016 there were about 20 international banks registered as clearing members of the SHCH through their Chinese subsidiaries.

In Europe, the European Commission must assess whether a CCP operating outside of the EU does so under an equivalent regulatory regime. The failure to do so results in a third-country CCP unable to



be recognised as a QCCP. Under Article 25 of the European Market Infrastructure Regulation (EMIR), there are rules that prevent European "covered persons" from participating in third-country CCPs that have not received recognition from the European Securities Market Association. In addition, under the Revised Capital Directive (CRD IV), European banks clearing through either a branch or a subsidiary will face risk weights of more than 1,250 percent on their exposure to a CCP that has not been recognised under EMIR.⁴⁸ However, when clearing on a QCCP the risk weighting is 2 percent. This increased capital charge is a significant disincentive for European banks to participate on non-recognised CCPs. The SHCH has yet to be recognised as a QCCP by the European Commission. However, in December 2016, the implementation date of the CRR was delayed until 15 June 2017.

In the US, there is a requirement under the Dodd Frank Act for third-country CCPs to either apply for recognition as, or exemption from, being a Derivative Clearing Organisation (DCO). Failure to do either will mean that US persons e.g. US banks and their overseas branches but not their overseas incorporated subsidiaries, clearing on a third-country CCP will be in breach of Section 5b of the Commodity Exchange Act as modified by the Dodd Frank Act. In April 2016, the SHCH wrote to the Commodity Futures Clearing Commission (CFTC) in the US requesting a period of no-action relief. Under this relief the SHCH would be permitted to temporarily clear swaps subject to the mandatory clearing obligation in China for the proprietary trades of US persons that are clearing members of the SHCH. Relief was granted for a period of one year until 31 May 2017, subject to a number of conditions, on the basis that the SHCH would petition for an exemption of the DCO registration requirement within six months of the effective date of the no-action relief.

Equivalence under EMIR and recognition or exemption as a DCO by the CFTC is particularly important in the context of the CIBM opening initiatives currently under way. Under these initiatives, international participants in the CIBM will be allowed to carry out a range of hedges, including CNY interest rate swaps that are subject to mandatory clearing. However, the ability of EU- and US-regulated entities to participate on this market will be hampered if the SHCH has failed to obtain equivalence or exemption status prior to the expiry of the current CRR implementation delay and the current CFTC no-action relief.

3. Omnibus and segregated account structures

Aggregators, like global custodians (GC), International central securities depositories (ICSDs), prime brokers, private banks etc. typically access markets using an omnibus structure for their end clients. This is already the case for China's H-shares and Stock Connect programmes which allow omnibus structure to trade multiple products.

However, but for the exceptions mentioned above, China generally operates under a segregated account structure model with individual investors opening accounts directly in the Central Securities Depositories (CSDs), which acts as a share registrar under Chinese regulation. Historically, this process was intended to protect domestic investors by allowing them to avoid counterparty risk with brokers. This is especially important during the early-stage development of a securities market. The

⁴⁸ Under BCBS's Capital requirements for bank exposures to central counterparties (<http://www.bis.org/publ/bcbs282.pdf>) all banks are required to hold capital against their exposures to CCPs. Europe is the only jurisdiction that links recognition of equivalence to QCCP status.



central registry allows investors to reclaim their securities more easily in the event their brokers become insolvent and prevents misuse and misappropriation of investors' assets by unscrupulous brokers.

As a market matures and opens to foreign institutional investors, the two account structures often co-exist. For example, Singapore requires segregated accounts for domestic retail investors but allows omnibus accounts for sophisticated and foreign investors. This arrangement provides the flexibility to accommodate needs of international investors without impacting domestic retail investors.

Omnibus accounts help sophisticated institutional investors access local markets more quickly and efficiently. These investors are already subject to rigorous home regulations such as UCITS V, AIFMD, the Dodd-Frank Act, the Securities Act of 1940, ERISA that require them to segregate the assets of their clients, or have those assets held by independent custodians.

The benefits of using omnibus account are primarily:

- Simplified market access for investors without necessity of registering and having an onshore service provider
- No account opening and KYC challenges involved for onshore investors
- Standardised services received for bond participation
- Provides RMB internationalisation with offshore RMB trading
- Helps aggregators to facilitate collateral management and in funding for trades

Leveraging these potential benefits we have the following recommendations that may be considered as an alternative to the segregated account structures currently in place:

- Onshore Local Custodians (LC) can open a special depository and a special cash account in the name of a GC and ICSD titled "LC for GC/ICSD" with the depositories and the LC
- These accounts will be nominee accounts where the onshore nominee, being LC, will hold securities for eligible end investors such as those who access CIBM through the GC/ICSD
- Where permitted by the Financial Action Task Force (FATF) regulations the LC can rely on the regulated intermediaries – GC and ICSD for KYC and/or AML of the investor where it is not opening any account for the investor or require any other documentation about the investor
- Require the investors and GC/ICSD to furnish any information and such details as specifically required by PBOC. Non-furnishing of such information by investor or by the GC/ICSD within a specified period will make the investor ineligible to trade in China securities. The GC/ICSD may also be penalised or disqualified to provide such services if so deemed appropriate by PBOC
- Investors accessing through an ICSD and GC should be permitted to trade with another investor with the same GC or ICSD, possibly, subject to certain conditions like:
 - Only DVP – RVP trades are permitted
 - Short selling is not permitted
 - Repurchase, borrowing and lending trades are permitted for financing and collateral management purposes
 - All such offshore OTC trades must be settled using offshore RMB



- All such OTC trades must be reported to CFETS by the GC or ICSD through the LC by T+1

4. Payment infrastructure

RMB is cleared domestically through the China National Advanced Payment System (CNAPS), a central bank operated RMB clearing system which provides real-time gross and net settlement. To have direct access to CNAPS a bank is required to have a settlement account at a branch of China's central bank.

As stated above, as of the end of July 2016, the RMB's use as a settlement currency was disproportionately small compared to the size of China's economy. One reason behind this has been the inadequacy of the infrastructure supporting cross-border RMB payments, which were made via a patchwork of clearing hubs and correspondent banks.

Payments were hindered by complicated routing procedures, the need to maintain multiple foreign correspondent accounts, liquidity shortages in some offshore RMB clearing centres, different hours of operation between clearing centres and a lack of common standards between international and Chinese domestic payment systems.

Currently, there are 19 RMB clearing centres globally, the latest being New York, which became a clearing centre in late 2016. Now all major financial centres and several key Chinese trading centres are serviced by a dedicated RMB clearing bank that facilitates RMB payment and settlement of transactions between market participants. Clearing banks reduce the risk on the RMB side of the transactions, while the non-RMB side can remain exposed to risks.

In 2015, China launched the CIPS, a cross-border RMB payment system, to address these issues. CIPS is a real-time gross settlement system that provides one-point entry for participants and a central location for clearing RMB payments by allowing direct access to onshore banks and indirect access to onshore and offshore banks.⁴⁹ Funding of CIPS accounts is completed via CNAPS. It has reduced the need for banks to navigate complicated payment pathways via offshore clearing hubs or through correspondent banks to facilitate faster payment processing and a reduction in cross-border payment costs.

CIPS is an important step to rectify deficiencies in RMB settlement and will play a critical role in its growth as an international payments currency. It is expected that, because payment messages are now supported in both English and Chinese and it operates the ISO20022 messaging standard and SWIFT bank identifier codes, cross-border payments made through CIPS should be able to achieve higher straight-through processing rates. In addition, the extension of its operating hours from 9:00am to 8:00pm Shanghai-time means the system now overlaps with business hours in Europe.

However, there are still improvements to be made. Chinese officials have spoken of a Phase II for CIPS that will improve liquidity management and the efficiency of cross-border clearing and settlement. These improvements could include longer operating hours to cover North and South America, net settlement functionality, support for securities settlement and central counterparties

⁴⁹ Data: CIPS



and the introduction of SWIFT as a channel for cross-border banks. To further grow the use of the RMB as an international payment currency there needs to be an increase in the number of international banks that are CIPS members. Currently there are eight international banks with an onshore presence.

Although the physical settlement infrastructure of RMB FX instructions has evolved considerably, in some aspects it might not comprehensively reflect and fulfil globally-agreed best practice standards:

- Settlement of RMB transactions is completed predominantly on a non-PvP basis. This exposes participants to principal risk (or Herstatt risk), the risk of a loss of the full value of the transactions. In line with the Basel Committee on Banking Supervision's Supervisory Guidance,⁵⁰ where practicable, banks should use financial market infrastructures (FMIs) that provide PvP settlement to eliminate principal risk when settling FX transactions
- Settlement of RMB transactions is not provided in central bank funds in all jurisdictions or in the counter-currencies. The CPMI-IOSCO Principles for Financial Market Infrastructures⁵¹ (PFMI) provide specific guidance as to settlement in central bank money to limit credit and liquidity risks
- Settlement of RMB transactions is usually on a gross or bilaterally-netted basis. Market participants are unable to realise the significant liquidity benefits of multilateral netting that are available to CLS-eligible currencies settled by CLS

As demand for RMB settlements continues to grow, it will increase pressure on liquidity and counterparty limits and on assuring risk mitigation for the notional amounts to be settled. For internationally active banks, holding separate pools of liquidity in various clearing centres makes it difficult to manage and makes liquidity at times expensive to obtain and unpredictable in terms of time of receipt.

RMB is the only top-10 currency ineligible for CLS settlement, as noted by the BIS,⁵² which prevents it from becoming a truly international currency. The adoption of CIPS by the international community has been slower than expected. However, it has the potential to significantly improve the efficiency of cross-border payments by improving settlement times and lowering costs as well as increasing liquidity in the market. To ensure its ongoing observance of international standards, CIPS should regularly complete and publicly disclose its self-assessment based on the CPMI-IOSCO Assessment Methodology of the PFMI.

5. Standardisation in post-trade

Complementing the need for modern trading technology, post-trade infrastructures modernisation should also be considered and not be left behind as has often been the case in economies across the region. The existence of multiple clearing and settlement infrastructures (CCDC, CSDC, CFETS, SHCH, etc.) covering different sometimes overlapping products makes the Chinese post-trade environment

⁵⁰ "Basel Committee on Banking Supervision Supervisory guidance for managing risks associated with the settlement of foreign exchange transactions." Bank for International Settlements, February 2013.
<http://www.bis.org/publ/bcbs241.pdf>.

⁵¹ "Principles for financial market infrastructures." Bank for International Settlements, April 2012.
<http://www.bis.org/cpmi/publ/d101a.pdf>.

⁵² "The rise and financialisation of the renminbi." BIS Quarterly Review, December 2016.
http://www.bis.org/publ/qtrpdf/r_qt1612u.htm.



complex and costly considering the different practices, communication channels and protocols that the market participants have to maintain. A mitigating factor to such an environment is the adoption of international communication standards such as the ISO 20022 universal financial industry message scheme and data standards such as the International Securities Instrument Number (ISIN).

Recommendations for Market Infrastructure

1. Create statutory provisions for settlement finality on transactions with CCPs and transactions across financial infrastructures in the Bankruptcy Law reflecting international standards enumerated in the CPMI-IOSCO – Principles for financial market infrastructures.
2. Allow the clearing member to create a security interest over cash in the margin account which is recognised by China's Property Law or Securities Law.
3. Prioritise the application of SHCH to be recognised as an equivalent CCP under EMIR and as an exempt DCO by the CFTC.
4. Provide foreign investors the option to use omnibus accounts to allow them to benefit from cost saving and efficiency they currently enjoy from other developed markets. This would allow a simplification in their operating model and improve time-to-market for new products by avoiding the need to open segregated accounts in the entire chain.
5. Ensure that the domestic market infrastructure is compatible with international standards, including the PFMI, in order to expand the use of the RMB as an international currency.
6. Settlement of the RMB on a PvP basis in central bank money accounts with multilateral netting would support the continued, stable expansion in the global use of the RMB for trade, investment and as a reserve currency, and meet internationally agreed standards.
7. Allow third party custodians to hold initial margin on behalf of the posting counterparty.



I. Market Access

China has a number of access programmes, each with its own set of criteria and objectives and often subject to specific restrictions (e.g. quota, lock-up periods, remittance of capital and repatriation of funds). The access programmes have been designed to complement, rather than replace, each other, and represent China's continuing efforts to facilitate cross-border flows. It is hoped that China will continue to open up its markets over time by addressing some of the issues identified below.

1. Foreign ownership limitation

During the past several years, China has continued to improve market access for foreign firms. The State Council, for example, released Measures on Further Opening up to Foreign Investment on 17 January 2017 which state that market access will be improved and equity caps will be lowered in a variety of service sectors, including banking and financial services, securities, securities fund management, futures and insurance services. However, the implementation of these measures is tied to the revision of the Foreign Investment Industry Catalogue, a draft of which was published for comments in December 2016. According to the draft Catalogue, it still requires that a majority of the shares of securities and fund management companies to be domestically held. Hence, many hurdles remain for foreign firms wishing to compete on an equal footing in the world's second-largest economy. Foreign financial services firms operating in China still face significant market restrictions, including limits on ownership stakes, licensing moratoriums and national treatment issues that prevent them from providing products and services that would facilitate the growth of the domestic capital markets. A level playing field for foreign and domestic financial services firms operating in China is a necessary precursor to developing and modernizing China's financial markets. To accomplish this, the foreign ownership cap of 50 percent for onshore securities joint ventures (JVs), trust JVs, asset management JVs and credit ratings agencies, among others, should be lifted.

Allowing foreign financial firms to establish wholly foreign-owned subsidiaries will benefit China's economy. Weak competition in the industry and constrained participation of international firms exacerbate challenges in the securities market such as inefficient capital allocation, excessive speculation of A-shares, lacklustre product development and innovation, and the inability of mergers and acquisitions deals to get beyond the initial stages. Allowing foreign firms to establish subsidiaries would attract more human capital, stimulate technology developed, improve risk management practices, and galvanise financial innovation. Foreign companies would bring more products onshore and/or relocate their subsidiaries from other parts of Asia to China. This would enhance Shanghai and other Chinese cities' positions as international financial hubs. It would also lead to more jobs and increased tax revenues.

Even if subsidiaries are permitted, however, competitive barriers would remain. Foreign brokers would continue to face challenges gaining market share as they lack the branch network needed to compete with domestic brokers in retail services. Hence foreign firms will focus on institutional clients. Notwithstanding their advantages, and perhaps in part because of them, the domestic securities sector is behind the banking sector in opening up to foreign investment. For this reason, despite the ongoing treaty negotiations between China and the US and EU, we recommend China



begin liberalising its securities sector as it does not now satisfy conditions for the necessary development of China's capital market.

Recently, there have been encouraging signs, with China allowing foreign financial institutions to set up Wholly Foreign Owned Enterprises (WFOEs) to engage in the private investment fund management business in China, e.g. raise funds and make investments in China. The Asset Management Association of China (AMAC) registered the first such WFOE as a "private securities investment fund manager" in January 2017 under the so called "WFOE PFM policy" and more such WFOEs are expected to be registered in the near future.

Many global asset managers expressed interest in applying for the WFOEs PFM registration with commitments to allocate resources to support their China business expansion plan. But, foreign firms may have to overcome various "technical difficulties", such as how to first obtain an appropriate corporate name and business scope registration for "investment-type" enterprises, because these repatriations were temporarily suspended in early 2017. It is still unclear when the local authorities will reinstate generally such repatriations.

Prior to AMAC's registration of PFM WFOEs, Shanghai, Shenzhen and some other cities in China had launched pilot programmes to allow foreign fund managers to set up WFOEs to raise funds within China but for investments offshore only. The most well-known of these programmes, QDLP and QDIE, were aimed at opening another channel outside of QDII to facilitate outbound investment. Given that these were all pilot programmes launched by local governments, it is not surprising that local governments require, among other things, that the WFOE be set up in their city as the pilot programme would be using the outbound investment quota of that city. As the business scope of foreign fund managers expands or changes, they may have to set up different WFOEs in another or multiple locations, which is not an efficient use of capital and other resources for these (or any) firms.

Foreign firms appreciate such initiatives from the local governments but also recognise the trial basis of such pilot programmes and the uncertainty over how and when such programmes will morph into a nationwide policy. Along with the unfolding of the WFOE PFM policy, it is hoped that, at some point, the authorities may allow a QDLP or QDIE WFOE to be converted to a PFM WFOE allowing a PFM WFOE to apply for various pilot programmes in different cities so that WFOEs can conduct business in different jurisdictions through one entity instead of multiple entities. We believe such integration of various policies, if achieved, would promote greater efficiencies, facilitate growth and more free flow of capital in the long run which are particularly important for the fund management industry where economies of scale, for example, would reduce not only the costs of doing business for fund managers but also the cost to the ultimate investors or purchasers of funds.

2. Bond underwriting licenses

International banks and financial institutions currently still have difficulty acquiring underwriting licenses despite significant experiences in this area. To get a license, for example, foreign banks must first receive approval from the underwriters already active in the market. Requiring a firm's competitors to approve its participation in the market is a significant obstacle for foreign banks. In addition, the current application-scoring mechanism disadvantages foreign banks by considering



only onshore business volume and ignoring the foreign applicant's offshore business. To date, only four foreign banks have received a sub-underwriting license, no foreign banks have obtained a full license that gives them a leading role in domestic bond deals. Moreover, the capital requirements for underwriters in China are higher than elsewhere.

3. Free trade zones (FTZs)

China's innovative initiatives with its FTZs are an encouraging sign for international investors. The move to a negative list-based investment scheme, in particular, was a welcome development. Although the Shanghai Pilot FTZ was slow to develop and its negative list remains longer than had been hoped for, many of the developments in the zone eventually proved to be beneficial. Free Trade Accounts (FTAs), cash pooling, the relative ease of issuing onshore bonds by an offshore parent company with a subsidiary in the FTZ, and several other financial services developments have benefited foreign firms. Late in 2015, PBOC and several other ministries also announced a new 40-point plan for the Shanghai FTZ aimed at furthering financial market liberalisation. While these announcements were positive steps, implementation has been slow. It is hoped China will reduce the length of the negative list as new FTZs are developed in other parts of China.

4. QFII and RQFII

Ever since the QFII regime was introduced in 2002, followed by the launch of the RQFII regime in Hong Kong in 2011, China has taken a step-by-step approach towards opening its capital markets to foreign investors. ASIFMA's recent global investor's survey on China's onshore bond market indicates that the QFII and RQFII schemes remain the most popular channels for foreign investors to access China's onshore bond market. With the gradual expansion of the RQFII programme from Hong Kong to other parts of the world, the QFII and the RQFII schemes are now available at almost all of the important financial markets around the world.

4a. Quota changes

As of 31 December 2016, CSRC has issued 305 QFII licenses and 217 RQFII licenses to foreign investors. The total investment quota allocated to QFIIs and RQFIIs as of 25 January 2017 reached USD 87 billion and RMB 529 billion, respectively. In 2016, SAFE introduced substantial changes to the quota allocation mechanism for both QFIIs/RQFIIs such that QFIIs and RQFIIs can now determine their own basic quota based on a certain percentage of their asset value or AUM (Basic Quota) or that of their group, and a routine filing with SAFE will suffice. If additional quota above their Basic Quota is needed, QFIIs/RQFIIs must then seek SAFE's approval.

The new Basic Quota filing system marks a milestone in the evolution of the QFII/RQFII regimes. It is expected to expedite investment by QFIIs/RQFIIs through a more transparent and streamlined process. In addition, capital repatriation for both QFIIs/RQFIIs may now be done on a daily rather than monthly basis and such repatriation will no longer reduce the quota of a QFII/RQFII, which means that the quota may be utilised on a revolving basis. Furthermore, the CSRC has removed the requirements that 50 percent of the assets of the QFII/RQFII must be invested in stocks and no more than 20 percent of such assets may be held in cash.

4b. Remittance and repatriation of funds

In addition, the previous six-month fund injection timeline for QFII and non-open-ended funds of RQFII has been removed, and the capital lock-up period has been shortened from one year to three months for non-open-ended funds starting from the date on which a specific amount (e.g. USD 20 million for a QFII, and RMB 100 million for an RQFII) has been remitted into China on an aggregate basis.

However, QFIIs are still subject to a monthly cap on repatriations equal to 20 percent of their total assets in China as of the end of the previous year. ASIFMA's recent China onshore bond market survey found that free repatriation of funds is the number one concern of international investors. Removing the monthly repatriation cap and lock up period will be key to attracting more international investors.

Moreover, notwithstanding the relaxation of repatriation rules by SAFE last year, foreign investors continue to experience difficulties in actually repatriating funds outside China due to tax clearance and audit requirements. These difficulties are a particular problem for foreign funds that invest through the QFII/RQFII regimes as they need to be able to meet redemption requests by their fund holders promptly.

Finally, as the rules for the QFII/RQFII regimes become more aligned, foreign investors would like to be able to switch easily from one regime to another without having to sell all of their investments under one regime before making investments in another regime. The problem with the latter is that it will give rise to unnecessary transaction costs and tax liabilities for the investors who want to keep invested in China and may actually trigger outflows, risking leakage.

5. QDII and RQDII

The QDII regime, launched in 2006, is a near mirror image of the QFII regime. It enables domestic Mainland Chinese institutional investors with a QDII license and quota approved by the China's regulatory authority to invest in offshore markets. Each QDII is granted a specific quota by SAFE.

Overview of the QDII Regime

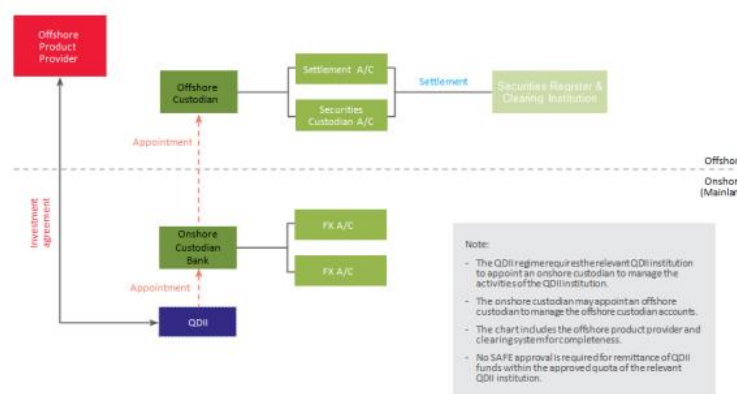


Figure 13: Overview of a QDII
Source: ASIFMA



Under China's Securities Law, a QDII institution (other than a QDII insurance company) is required to repackage an offshore investment product as its own QDII product for sale to its domestic investors.

Chinese regulators impose different requirements on QDII institutions with respect to:

- The channels through which QDII institutions may raise funds onshore
- The onshore selling activities that QDII institutions may undertake
- The investment criteria that onshore investors must satisfy
- The investment restrictions that QDII institutions shall observe

As a result of the different QDII regulatory regimes, different categories of QDII institutions are subject to different types of permissible offshore investments. There are also various types of investment restrictions applicable to different offshore investment products invested in by different types of QDII institutions.⁵³

The RQDII regime, which was launched in 2014, permits RQDIIs to invest in overseas RMB denominated products using their own RMB funds or RMB funds raised from China's institutional or individual investors.

Unlike the QDII regime, RQDIIs do not need to be granted a quota by SAFE. Qualified RQDIIs may invest as much RMB funds as they are able to raise from domestic investors, provided that the amount of funds is within the maximum amount reported to or approved by the regulatory authorities.

However, China stopped approving quotas for QDIIs/RQDIIs as of December 2015 and is not expected to approve any more quotas in the near future due to, among other things, concerns over capital outflows.

As QDII/RQDII is another important access channel for foreign asset managers, we would like to see these regimes opened again in the near future.

6. Stock Connect⁵⁴

The Stock Connect programme was first conceptualised by China as another channel for opening up China's capital market. In November 2014, mutual market access between the SSE and HKEX was established representing the first time that two stock exchanges have linked up in this way.

The typical route for investors to buy stocks in another country is through a relationship between the broker in its originating country and a correspondent broker in the target country. Stock Connect, by contrast, is a direct link between exchanges. The link enables brokers who are members of the HKEX to execute orders through a link to the SSE, rather than to broker members of the SSE.

As China's capital account is restricted, foreign investors are not allowed to open accounts at financial institutions except in specific approved purposes. Stock Connect enables Chinese authorities to allow money to flow in and out of shares through a single controllable conduit.

⁵³ "ASIFMA Report: Access Programmes and Reforms in the Cross-Border RMB Market." ASIFMA, April 2016.

⁵⁴ For the purpose of this paper, the discussion will only focus on the northbound leg of the Stock Connect, through which offshore investors are provided access to the Mainland Chinese A-share market.

Investors must purchase CNH in Hong Kong or have their broker arrange a purchase on their behalf. When a foreign investor sells shares through Stock Connect, the RMB proceeds are delivered in Hong Kong. Stock Connect creates a “closed loop”, segregating the RMB used to buy shares from the rest of the Chinese economy.

Stock Connect allows any investor in the world, institutional or retail, access to A-shares. There are no lock-up periods or repatriation restrictions for Stock Connect. In contrast, QFII and RQFII, which have been steadily liberalised over the years, are restricted to approve institutional investors.

With the success of the Shanghai-Hong Kong Stock Connect, Shenzhen-Hong Kong Stock Connect was launched on 5 December 2016. In contrast to the large SOEs that predominate on the SSE, SZSE listings are tilted towards small and mid-caps, with a significant proportion of companies from cutting-edge industries such as software, high-tech and biotechnology. As a result of the addition of Shenzhen Connect, Stock Connect now provides investors with a much wider menu of equities and considerably increased opportunities for diversification and stock selection.

Breakdown of Market Cap by Sector and Ownership Structure of SZSE and SSE

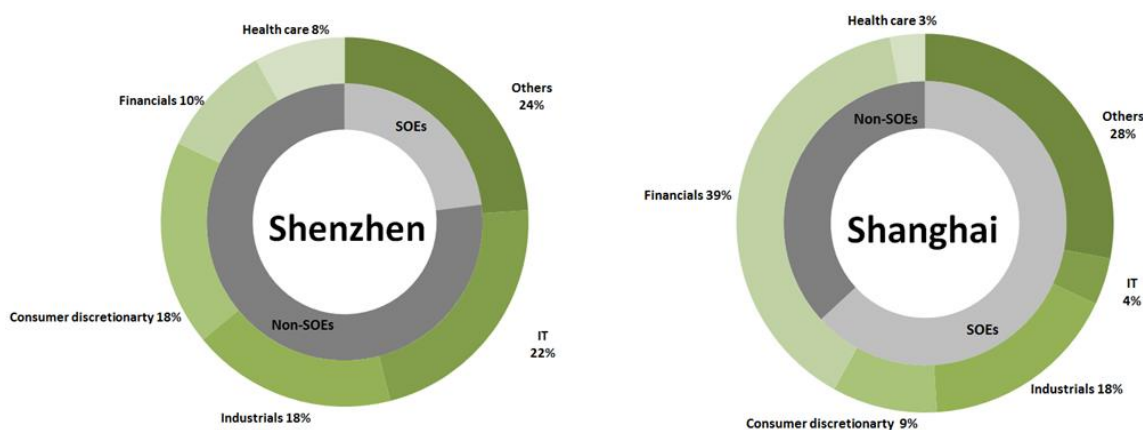


Figure 14: Breakdown of Market Capitalisation of SZSE and SSE by Sector and Ownership as of Jan 2017
Source: HKEX

6a. Quota

When Shanghai-Hong Kong Stock Connect was launched, an aggregate quota of RMB 300 billion for Northbound and RMB 250 billion for Southbound trades put an upper limit on total investment allowed through this connect in either direction. Its size was limited initially to allow authorities and market participants to evaluate the link. After nearly two years of problem-free operation, the aggregate quotas in both directions were abolished in August 2016, when the Shenzhen Connect Link was announced.

For similar reasons, there has been a daily quota of RMB 13 billion for Northbound trading and RMB 10.5 billion for trading. These quotas remain in effect. The Shenzhen leg gets its own RMB 13 billion quota, however, so that the total daily quota for the Stock Connect programme is RMB 26 billion with launch of Shenzhen-Hong Kong Stock Connect. The Northbound daily quota has been fully utilised once, on its launch date November 17 2014; the Southbound twice, both times in April 2015.



Quotas are problematic for institutional investors because a quota may unexpectedly prevent the execution of a buy order and throw the portfolio out of alignment of investment mandate. Straying from an investment mandate whatever the reasons creates “tracking error”, the deviation of portfolio performance from its benchmark and a key measure of a fund’s performance. Quotas are an implicit cost and elimination of the aggregate quota gets rid of part of the risk. Though the Northbound daily quota was hit only once e.g. on the day it was launched, Northbound investment could increase substantially, along with the risk of hitting the limit, when A-shares get approved for index inclusion for MSCI Emerging Markets.

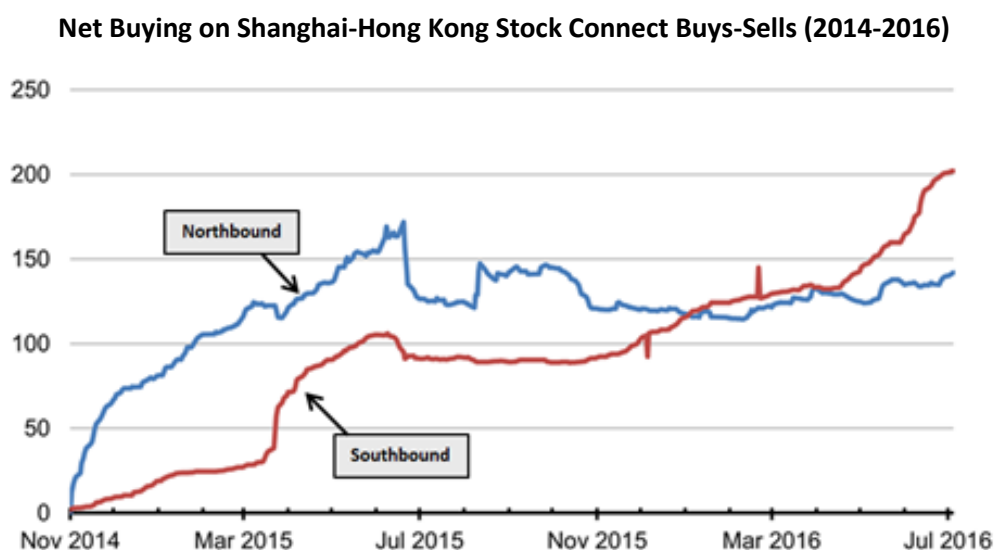


Figure 15: Net buying on Shanghai-Hong Kong Stock Connect in RMB Billions from Nov 2014 – July 2016
Source: Thomson Reuters, WSJ

6b. Legal, regulatory and operational implications

The basic principle with Stock Connect is home country rules apply. Hong Kong brokers and investors offering A-share products are subject to the Securities and Futures Ordinance and SFC regulations. In practice it is more nuanced and regulators on both sides of the border cooperate. At the beginning, foreign investors were concerned of their legal claims to A-shares because the shares are held in an HKEX omnibus account, lacking specific customer information. The CSRC, however, issued FAQs in May 2016 which have largely addressed this concern, which the MSCI noted the following month even though it decided not to include A-shares into its index.

The key operational issue in China is that stocks are settled on T+0, but the payment settles on T+1. This is in contrast to the method used in most developed markets, where stock and cash settle on the same day, usually on T+2. Brokers, custodians and HKEX have devised ways which have largely overcome the disconnect in settlements, though some operational and counterparty risk remains. As discussed in this paper’s section on equity markets, we believe a DVP structure for equity settlement would significantly enhance the attractiveness of China’s equity markets to global investors.



6c. Short selling

Short selling is permitted in theory but because of the way the rules are written it is been impracticable and not a single short sale has taken place on Stock Connect as of January 2017. A short seller has to borrow a stock in order to sell short. The rules allow HKEX Participants (EPs) to lend stocks, but EPs typically don't have inventories of stocks to lend. Asset managers and custodians usually do. As a result, there have been no short sales by Northbound Stock Connect investors since its launch. This is unfortunate because short selling facilitates various investment strategies and is an important element in supporting market liquidity, particularly when markets are stressed. It is hoped the Chinese authorities will amend the rules to allow affiliates of EPs such as asset managers and custodians to engage in stock borrowing and lending on Stock Connect. This would make short selling feasible.

6d. Block trades

Block trades are important tools used by institutional investors to manage trading costs as they adjust their portfolio. Block trades are not permitted under current Stock Connect rules and we recommend revising the rules to permit this important tool.

6e. The future of Stock Connect

HKEX announced plans for product additions to Stock Connect, in particular ETFs, IPOs, exchange-traded derivatives, and eventually warrants. ETFs traded in Hong Kong could be of particular interest to Southbound investors, who could use global or regional ETFs easily diversify their portfolios. For some Northbound investors, Chinese ETFs might be attractive given the limited acceptance of A-shares by index managers outside of China.

Stock Connect could also embrace exchange-traded derivatives (ETD), such as the CSI 300 contract traded at CFFEX or the Hang Seng Stock Index futures in Hong Kong. The availability of CSI futures will open possibilities for improved portfolio and risk management for offshore China investors. HKEX also trades currency futures and has the world's most active market in warrants and structured products such as callable bull/bear contracts (CBBCs), all of which could become part of the Connect programme eventually.

Authorities have announced intentions to eliminate capital controls as early as 2020. When that happens, foreign investors will be able to buy RMB and invest in any Chinese assets more or less without restriction (or subject to the same restrictions as a domestic investor). Given how cross-border investing works in the rest of the world, one might expect Stock Connect to be replaced by the global model. It is also possible that Stock Connect may by then have become a familiar part of the investment process by then. If HKEX maintains a high level of service, Stock Connect could survive. The key to success will be to ensure that Stock Connect provides diverse investors market access efficiently and at a low cost.

7. Mutual Recognition of Funds

CSRC and SFC jointly announced on 22 May 2015 the decision to launch the Mutual Recognition of Funds (MRF) scheme between Hong Kong and China, with an initial quota of RMB 300 billion for



Hong Kong and Mainland funds. The MRF was launched on 1 July 2015 with the first batch of three Hong Kong (Northbound) funds approved by the CSRC and four Chinese (Southbound) funds approved by the SFC on 18 December 2015. As of January 2017, a total of six Northbound funds and a total of 48 Southbound funds have been approved.

Given the large discrepancy in the total number of Northbound and Southbound funds that have been approved, the fund recognition or approval process for Northbound funds can benefit from greater transparency and improvement. Even though only six Northbound funds have been approved to date, they collectively raised RMB 10.22 billion as of the end of December 2016 compared with the RMB 152 million raised by the Southbound funds as of the same date. Concern over the depreciation of the RMB and uncertainty about China's economy may be some of the reasons for the lack of investors' interest in the Southbound funds. On the other hand, the same reasons coupled with a desire for diversification may explain Mainland investors' strong demand for the Northbound funds.

As the MRF scheme develops, it is hoped that different types of funds and other products will be included in the scheme so that investors in China and Hong Kong have more choices as currently only the plain-vanilla type of funds is approved. Also, allowing partial investment management delegation outside of Hong Kong would expand the eligible product range, e.g. exposure to global markets. This would diversify Chinese investors' investments and more importantly, reduce the risks that they face from over-concentration. It is hoped that the requirement that at least 50 percent of the AUM of a fund must come from the fund's home jurisdiction would be adjusted in the case of a Hong Kong domiciled fund given the small size of the Hong Kong market compared with the Mainland.

8. CIBM opening

CIBM is an OTC market launched in June 1997 when the PBOC mandated all commercial banks to move their repo and bond trading out of the stock exchanges and into an interbank market operating through an electronic trading system. The major debt instruments traded in the CIBM are government bonds, central bank bills, financial institution bonds and other debt financing instruments. CIBM has become China's dominant bond market (accounting for more than 90 percent of China's total outstanding bond volume in custody). Together with bonds traded on China's two stock exchanges, China's bond market is the third largest in the world after the US and Japan.

8a. Liberalisation process

China began opening the CIBM to foreign investors starting in 2005 when the Pan-Asia Fund and Asia Debt China Fund were allowed to invest in the CIBM. The liberalisation truly commenced in 2010 when the "three types of foreign institutions", e.g. the overseas central banks/monetary authorities, the RMB clearing banks in Hong Kong and Macau, and overseas banks engaged in RMB cross-border settlement, were allowed to trade and settle bonds in the CIBM. Further liberalisation followed when Hong Kong-based RQFIs were allowed to invest in the CIBM in 2011, then extended to insurance companies in Hong Kong, Singapore and Taiwan in 2012, QFIIs in 2013 and subsequently all RQFIIs.



The pace of the CIBM opening to foreign investors increased significantly when PBOC announced in July 2015 that foreign central banks, monetary authorities, international financial organisations and sovereign wealth funds (collectively the Sovereign Institutions) would be allowed to invest in the CIBM without any approval requirements or quota limits and subject only to filing with the PBOC. In February 2016, the PBOC announced that most types of foreign institutional investors would be permitted to invest in the CIBM through the new filing without the need for prior approval or quota allocation (“the Direct Access regime”). These include foreign commercial banks, insurance companies, securities firms, fund management companies, their investment products, pension funds, charity funds and endowment funds, and other medium- and long-term institutional investors recognised by PBOC. Initially, the regulators indicated that the same institution should not use both the Direct Access regime and the QFII/RQFII regime to invest in the CIBM. However, they have clarified that foreign institutions may use both channels for their different clients and/or products.

8b. Medium and long-term investors

The PBOC’s rules on the Direct Access regime leave it to the settlement agent banks to determine whether a foreign institution is a medium- or long-term investor for purposes of qualifying for this regime. It would be helpful if the criteria used for such determinations were standardised and not kept to individual settlement agent banks to determine.

8c. Hedging onshore

Unlike equity fund investors, it is very common for global bond funds to invest on an onshore currency hedged basis. It is, therefore, crucial for foreign bond investors to be able to hedge RMB currency exposure through the onshore FX spot and forwards market. Furthermore, foreign investors would want to engage in interest rate hedging activities including the use of onshore interest rate swaps and bond futures. Unlike foreign central banks and monetary authorities, which have access to China’s onshore bond futures market, foreign institutional investors are currently not allowed to participate in bond repo trading for the time being. Access to onshore hedging instruments is critical to foreign investors’ participation in the CIBM.

8d. Bond-linked products

After overseas institutional investors successfully enter the CIBM, the fact they hold onshore bonds would trigger other considerations. These include questions such as whether investors may issue offshore market access products linked to bonds traded in the CIBM (such as those who do not qualify as eligible investors themselves), and whether offshore credit-linked products are permitted to help foreign investors hedge the risks of potential bond defaults and taking security over onshore bonds. Clarification of the foregoing would help to promote increased offshore interest into CIBM.

9. Bond connect

In addition to the CIBM, investors may also consider accessing China's bond market via the bond connect scheme which was officially proposed in the 13th China's Five-Year Plan. Little detail has been released by the Chinese government so far as to the mechanism of this scheme. However, according to the Strategic Plan 2016-2018 of the Hong Kong Stock Exchange, mutual market access



between Mainland China and Hong Kong in the institutional cash bond market is being explored. Similar to the design of the Stock Connect, cross-border cash bond trading may be available for foreign investors via a platform in Hong Kong in the near future. The market is expecting more details and a faster pace for this innovation.

To satisfy global investors' increasing demands for the RMB-dominated financial products following RMB's inclusion in the SDR basket, the Chinese government has been taking continuous initiatives to relax restrictions in China's capital markets, including the opening-up of the CIBM. Undoubtedly, increased foreign participation will bring greater liquidity to the China bond market, which in turn would benefit investors in sharing the fruit of China's market potential and her continuous economic growth.

10. Panda bonds

Panda bonds – or RMB-denominated paper issued in Mainland China by foreign borrowers – have seen an explosive growth since China resumed strong policy support for the market a year ago. The outstanding amount has increased ten-fold during the time period, to RMB 78.4 billion, and July 2016 was the busiest month in terms of issuance as it jumped to RMB 21.8 billion.

We believe that the surge in activity is only the beginning of what should shape up to be Asia's most important new market in the coming decade. Such an optimistic view is based on the attractiveness of panda bonds to issuers as well as investors, and strong policy support.

The panda bond market is highly attractive to issuers, both onshore and offshore, because it offers them unique opportunities. Firstly, for those planning to use the raised funds onshore, panda bonds enable easier utilisation of proceeds than when issuing offshore (where remittance onshore is more complex due to regulatory barriers). Second, panda bonds offer the ability to reach new categories of bond buyers (international investors). Thirdly, at times, for example currently, they provide an opportunity to raise cheaper financing than in the dim sum, Formosa or Lion City bond markets (this advantage depends on relative funding costs onshore versus offshore).

The panda bond market is also attractive to investors, both onshore and offshore, as it offers advantages to each. Panda bonds offer domestic investors access to issuers otherwise unavailable onshore, and free access to issuers available offshore only via special programmes (QDII, RQDII). They provide foreign investors with access to issuers not available in the offshore markets and in the rest of the onshore market, including foreign issuers with international ratings higher than even those of CGBs (e.g. ADB).

Chinese regulators will most likely continue to offer strong support to the panda bond market. Recent measures include opening the CIBM to foreign central banks, sovereign wealth funds and supranational institutions (July 2015). In October 2015, offshore issuers were given freer access to the onshore market. In February 2016 the authorities opened the CIBM market to foreign institutional investors, a dramatic opening.

However, there are a few unresolved issues. In practice, only a subset of issuers, including sovereign and quasi-sovereign issuers (such as the multilateral agencies like the ADB) can readily access the



market. Also, as of early 2017, only entities that have a Hong Kong presence are audited in Hong Kong meet China's audit/accounting equivalence standards. Submissions have been made to Chinese authorities to allow entities in other jurisdictions that follow IFRS/US GAAP to be granted equivalence for accounting/audit purposes. As the rules stand currently, all potential panda bond issuers must present the past three years of financial statements in a format that meets Chinese accounting standards. If this issue is resolved satisfactorily, a greater volume of panda bond issuance from a greater range of issuers (including international corporates) will likely arise. We suggest China consider admitting the place-of-origin accounting principles at least to the extent they are compliant with IFRS or substantially compliant with IFRS. In addition, Chinese regulators exclude US GAAP from their acceptable accounting standards. As a result, US financial institutions and corporations are not able to issue bonds in the interbank bond market. Conversely, however, Chinese accounting systems, being itself a framework of accounting standards that are substantially compliant with IFRS, are accepted by US financial regulators.

The current application scoring mechanism for obtaining the membership of NAFMII disadvantages foreign banks. For example, the process sorts applications by onshore business volume excluding the business of offshore parent companies and compares with domestic banks' onshore parent companies, where Chinese domestic firms have an advantage.

Another issue is that panda bond issuers are required to obtain at least one credit rating from a domestic credit ratings agency. Given that the domestic scale of ratings in China is different from international ratings standards, in terms of ratings framework, methodology and operation, this could result in a different domestic rating, compared to global standards. In addition, the credit-risk analysis of panda bonds is more complex given that they are denominated and distributed in a functional currency of a jurisdiction other than that of the issuers. Even so, at the margin, panda bonds do provide an impetus to the internationalisation of the rating industry in China.

In the medium to longer term, despite the short-term impediments, the seriousness of Chinese authorities on market opening measures gives reason for optimism about the continued growth and development of the panda bond market.

We believe, based on the history of their analogues such as Yankee, Kangaroo, and Samurai bonds that panda bonds will eventually grow to about 15 percent of the international RMB bond market, e.g. Dim Sum, Lion City, and Formosa bond markets. At the same time, this international portion collectively should rise towards 50 percent of all RMB bonds, a portion that is the current average of international portions of the USD, Yen and AUD bond markets. Finally, the overall RMB bond market will likely grow as a share of China's GDP to about 150 percent.

Assuming that about two-third of these forecasts will materialise by 2025; we estimate that the face value of panda bonds by then will be over RMB 13 trillion, or USD 2 trillion. This would correspond to almost 7 percent of total onshore RMB bonds outstanding or nearly 10 percent of China's GDP.

11. Credit ratings

Credit ratings and research help investors analyse the credit risks associated with Fixed Income securities and other financial obligations. For international investors interested in the Chinese



domestic bond markets, credit ratings issued by domestic credit rating agencies (CRA) are helpful in such credit risk analysis. However, many of the international investors would be particularly interested in credit ratings issued by international CRAs.

Over the course of their history, international CRAs have adapted to market needs so that credit rating systems have developed certain key attributes, including:

- Opinions supported by insightful and robust analysis
- Symbols that succinctly communicate opinions
- Public availability of opinions
- Broad coverage across markets and industries that allows for comparability.

Credit ratings promote dialogue and debate among market participants, which in turn help further the integrity of the debt markets and understanding of credit risk. The credibility and global comparability of the credit ratings issued by international CRAs are particularly important for international investors.

11a. Credibility

International CRAs have long histories of issuing credit ratings, and international investors trusted credit ratings issued by these CRAs due to the long-term performance record of such ratings. As an example, below are the three-year default rates of non-financial corporate issuers and financial corporate issuers rated by one international CRA, as well as the average cumulative default rates for global corporate finance rated by another international CRA. As shown in the charts, the frequency of default increases down the rating scale. This demonstrates the effective rank ordering of credit risks and the predictive value of credit ratings issued by this international CRA.

If ratings of Chinese bonds will be issued by international CRAs, such ratings will be perceived as having predictive value by international investors. They can thus increase awareness of RMB denominated issuance and help international investors better understand Chinese bonds.

At the moment, the top ten Chinese rating agencies award investment grades to 99.5 percent of all publicly-offered debt.⁵⁵ Following legal reforms, ratings agencies will likely be required to reassess assumptions about the likelihood of automatic government bailouts and broaden the range of their ratings.

⁵⁵Kynge, James. "China's domestic credit rating agencies see no debt problem." The Financial Times. July 1, 2016. <https://www.ft.com/content/dca6f042-3ec8-11e6-8716-a4a71e8140b0?siteedition=intl#axzz4K6lrH9h9>.



Average Three-Year Default Rates (1920-2015)

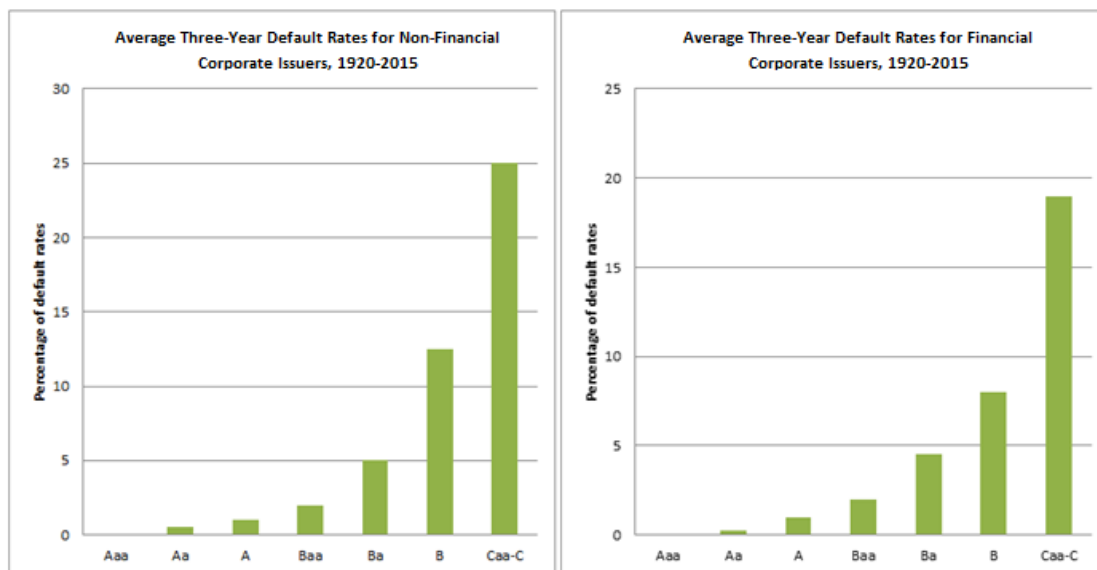


Figure 16: Average three year default rate from 1920-2015
Source: Moody's

Global Corporate Finance Average Cumulative Default Rates

Percentage	One-Year	Two-Year	Three Year	Four-Year	Five Year	Ten-Year
AAA	0.13	0.26	0.39	0.53	0.68	1.3
AA+	-	-	-	-	-	-
AA	-	-	-	-	-	-
AA-	0.09	0.10	0.1	0.1	0.11	0.05
A+	-	0.07	0.13	0.19	0.26	0.54
A	0.09	0.26	0.48	0.7	0.96	2.17
A-	0.08	0.18	0.33	0.42	0.52	1.94
BBB+	0.12	0.21	0.36	0.64	0.86	1.94
BBB	0.07	0.37	0.75	1.16	1.72	3.62
BBB-	0.32	0.92	1.57	2.2	2.91	6.34
BB+	0.36	1.72	3.23	4.51	5.83	9.7
BB	0.62	1.91	2.96	4.84	6.35	12.6
BB-	1.31	2.49	4.15	4.82	5.16	7.35
B+	1.28	3.67	5.68	7.32	8.33	9.11
B	2.06	4.57	7.19	9.4	11.65	13.64
B-	2.96	5.62	6.19	7.44	7.33	5.41
CCC to C	21.36	27.96	31.41	33.85	35.38	33.87
Investment Grade	0.10	0.28	0.49	0.71	0.94	1.97
Speculative Grade	2.60	4.68	6.48	8.08	9.26	11.82
All Global Corporate Finance	0.69	1.30	1.84	2.32	2.71	3.66

Figure 17: Global corporate finance average cumulative default rates as of Jan 2017
Source: Fitch

11b. Comparability

Credit ratings issued by international CRAs establish commonly understood points of reference that enable comparison across markets, industries and geographies. China is a market of increasing importance and interest to international investors. As part of their analytical work, international



investors will be looking for the views of international CRAs to help them understand the relevant credit worthiness of a Chinese bond versus other bonds. For example, an investor can look at a debt issuance in Finland with a BB rating and debt issuance in Brazil with a B rating, and easily understand the international CRA's opinion on their relative credit worthiness.

ASIFMA's global investor's survey on "Accessing Mainland China's Onshore Bond Markets" further illustrates the importance of international CRAs to international investors. According to the survey results, "coverage of issuers by international credit rating agencies" is listed by 60 percent of the respondents as either the number one or number two concern (out of five) with respect to credit information.

While our discussion focuses on the investor side, participation by international CRAs will also benefit the issuers in the domestic bond market, whether they are domestic or international issuers (in the case of panda bonds).

Altogether, international CRAs can serve as the bridge for capital flow from international investors to the Chinese domestic market if they participate in rating Chinese domestic bonds. We are thus encouraged by the recent proposals by the Chinese government to remove foreign investment restrictions on the CRA sector, and recommend that Chinese regulators welcome the participation of international CRAs by (1) facilitating international CRAs to operate in Chinese market without restrictions, and (2) creating a regulatory environment that is consistent with the international standards set forth in the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies.

12. Tax certainty

12a. Withholding tax treatment

The withholding tax mechanism for interest payment on CIBM bonds to offshore investors should be clarified and urgently implemented. Under existing law there is a withholding tax, but there has been no mechanism to withhold and collect the tax. We recommend that a mechanism should be put in place for the tax to be withheld by the relevant clearing houses on a cash basis, and the mechanism for treaty benefit claims. At the same time, the SAT should also clarify the treatment of back-taxes owed and transitional provisions for implementation of withholding.

One key stumbling block for cross-border issuances is the existing 10 percent withholding tax in place for offshore remittance of interest collections. Removal of this tax for securitization transactions would go some way in encouraging cross-border issuances to offshore investors.

12b. Foreign Account Tax Compliance Act (FATCA)

China agreed in substance to enter into a Model I Intergovernmental Agreement (IGA) with the US in order to implement FATCA, which became effective 1 July 2014. More than two years have passed and IGA negotiation is still underway. In July 2016, the US turned up the heat with Announcement 2016-27 requiring jurisdictions which agreed in substance or already signed an IGA but not yet put into force to provide a detail step by step plan and timeline for signing or bringing the IGA into force. The US will review and remove jurisdictions which failed to demonstrate firm resolve to enter or bring an IGA in force beginning January 2017.



If China is being removed from the list, financial institutions in China will be required to comply with FATCA Regulations. Under FATCA Regulations, financial institutions are required to due diligent new and existing accounts, withhold on US source payments to non-participating foreign financial institutions (NPFIs), and report directly to the US Internal Revenue Service (IRS) on reportable accounts. Since existing Chinese laws do not allow financial institutions to withhold and report, Chinese financial institutions will be regarded as NPFIs. According to FATCA requirements, NPFIs cannot open US accounts, must identify itself as 'non-participating' to withholding agents, will be subject to 30 percent withholding on US fixed, determinable, annual or periodical income payments (FDAP) and being reported to the IRS.

While China is still on the list of countries agreed in substance to enter into an IGA, as of January 2017, the list continues to be monitored for changes by the IRS. In the meantime, financial institutions need to liaise with their regulator and government authorities for the release of the draft guidance and detail to reporting so that the industry can be more prepared to comply. In the meantime, we urge relevant government authorities in China to maintain dialogue with the IRS to ensure China remains on the list and ultimately enter into the IGA.

12c. Common Reporting Standard (CRS)

Common Reporting Standard (CRS) is an Organisation for Economic Co-operation and Development initiative to increase tax transparency by requiring financial institutions in adopting jurisdictions to report account holder information where an account is held by a resident of a partner jurisdiction. More than 100 jurisdictions have committed to adopt CRS by entering into multi-lateral or bilateral Competent Authority Agreement (CAA).

CRS requires financial institutions to identify the tax residency of the financial account holders and report the relevant information to the local tax authority (in the case of China, it is the SAT). Tax residency information will be collected via indicia search and/or self-certification. Accounts held by a resident of a jurisdiction which China entered into CAA are to be reported to the SAT. Information to be reported includes, but not limited to, personal information, account balance and payments. Since CRS is implemented through enactment of local laws, non-compliance will be penalised under Chinese laws.

China signed the multi-lateral CAA on 17 December 2015 confirming its commitment to implement CRS by 1 January 2017 and exchange of information by September 2018. China released draft legislation and FAQ in mid-October 2016 for public consultation. As of January 2017, China has not released the final legislation and FAQ.

We urge the SAT to release final legislation, FAQ and maintain an ongoing dialogue with the financial industry. At the same time financial institutions are recommended to liaise with the SAT for a workable solution and to conduct a gap assessment on existing processes and systems to enable compliance once legislation is released.



13. Cybersecurity

The Cybersecurity Law adopted on 7 November 2016 will introduce significant requirements for financial services and technology providers to enhance cyber and network security, such as increasing data protection and restricting the mobility of data collected onshore. While it is important for governments to implement cybersecurity standards and regulations, as well as to protect the confidentiality of the data of its citizens, this should not be detrimental to financial service providers' abilities to conduct legitimate business in China. The current law by the National People's Congress Cybersecurity Law is broad, vague, opaque and restrictive and we are concerned that this will make the business and investment climate in China more unpredictable. The legislation, set to take effect in June 2017, is hoped to become more flexible before its implementation.

The concern by financial institutions is that financial services companies would be designated "Critical Information Infrastructure Operators" and need to comply with potentially onerous standards, certification and inspection processes, provide cybersecurity plans, and submit to opaque enforcement regimes. Many of these proposals are similar in scope to the CBRC's directive on Secure and Controllable Information Technology, which was of grave concern to the industry earlier in 2015.

Financial services companies will potentially need to comply with onerous, overlapping and contradictory rules emanating from sectoral regulators, each of which will be responsible for implementing these regulations. Regulators related to financial services include, but are not limited to - the CBRC, CSRC, CIRC, PBOC and the Ministry of Industry and Information Technology. The potential for overlap between sectoral regulators' requirements, as well as existing rules is obvious.

The restriction on global financial services firms' abilities to share data with their offshore group affiliates would introduce inefficiencies and business uncertainty, jeopardise their ability to comply with international regulatory commitments, as well as hinder their ability to provide services for onshore clients. Other issues which are of particular concern include: personal data requirements, on-shore data storage, domestic encryption standards and real name requirements.

The current Cybersecurity Law would adversely impact the business and investment climate for both foreign as well as domestic firms. The Cybersecurity Law and any other security legislation should enable sectoral regulators to carve-out functions that are critical to the integrity and stability of the financial system in China, such as those provided by financial services firms. It is hoped China becomes more flexible with its interpretation ahead of its implementation.

14. English language

A major impediment for more global investor interest is language. English is the internationally recognised language for the financial sector and services. Chinese authorities are encouraged to implement and standardise the use of English in announcements widely in consultations, circulars, market and technical documentation, etc. to facilitate communications with global financial markets.

Recommendations for Market Access

1. Remove the foreign ownership cap for securities, trusts, asset management, and credit ratings entities.
2. Harmonize the requirements of similar access programmes with a view towards future



- consolidation and/or alignment to improve efficiencies.
3. Provide a level playing field by allowing international banks and financial institutions to acquire underwriting licenses on a fair and transparent basis.
 4. Remove all repatriation limits and quotas across all access programmes.
 5. Amend the rules on Stock Connect to allow affiliates of Exchange Participants, such as asset managers and custodians, to engage in stock borrowing and lending, and to permit block trades under Stock Connect.
 6. Improve the transparency and efficiency of the Northbound fund approval process under the MRF.
 7. Allow foreign investors in China's bond markets to hedge onshore.
 8. Increase the range of issuers (besides just the sovereigns and quasi-sovereigns) for panda bonds, allow international CRAs to rate panda bonds and allow flexibility in accounting rules in line with global standards (particularly for US GAAP).
 9. Allow international CRAs to operate without restrictions and promote regulatory environments that are consistent with the international standards set forth by IOSCO's code of conduct.
 10. Allow foreign investments into an onshore trust holding for securitised assets.
 11. Clarify the withholding tax on bond interest and place a mechanism for tax to be withheld by the relevant clearing houses on a cash basis and for treaty benefit claims.
 12. Enter into a Model 1 IGA with the US to comply with FATCA and have the SAT release the CRS final legislation, FAQ and maintain an ongoing dialogue with the financial industry.
 13. Adopt a flexible interpretation of the Cybersecurity Law at the implementation level for the financial industry.



J. List of All Recommendations

1. Equities

- Rigorously implement reforms in trading suspension rules to ensure stocks continue trading except under exceptional conditions set out in transparently applied rules.
- Develop a SBL environment to enhance overall equity market efficiency and to enable efficient short selling.
- Facilitate increased participation by institutional investors by encouraging participation of insurance companies and pensions funds.
- Allow alternatives to exchanges such as MTFs and ATSS.
- Widen allowable price moves for equities and consider reintroducing circuit breakers.
- Reform the pricing of IPOs by allowing market forces to determine prices.
- Adopt transparent rules for delisting sub-standard companies.
- Clarify short swing profit rule as they relate to fund managers to allow holdings to be calculated on an individual client/fund basis.
- Move to a settlement cycle where cash and stock settle simultaneously e.g. DVP, to protect investors (e.g. to T+1).
- Promote investor education programmes that teach key principles of investment such as an understanding of risk, the role of diversification, and the importance of building a portfolio with an appropriate investment horizon.

2. Fixed Income

- Broaden the range of financial instruments that can be used to satisfy bank liquidity requirements, and reduce the absolute level required.
- Adopt best practices based on global standards in information disclosure, for the prospectus/issuing document at the time of the new issue and on a continuing basis.
- Strengthen the financial, legal and business due diligence process in the primary markets.
- Streamline the bookbuilding process to provide flexibility in price determination similar to the process used in international offerings.
- Create a liquid classic repo framework for the repo market.
- Allow banks, which are the major holders of bonds, to participate in the bond futures market.
- Issue guidelines for offshore investors and other market participants on the Chinese domestic CDS market.
- Formalise the central clearing of CDS and the designation of CCPs to mitigate counterparty risk.
- Harmonise the different securitisation regimes to create a bigger, deeper and more liquid securitisation market.

3. FX

- Encourage greater competition in electronic execution by allowing other platforms to collaborate or to compete with CFETS thereby improving efficiency and driving down the costs of execution.



- Introduce new products to provide end users with a wider opportunity to hedge their currency exposures at a lower cost.
- Refrain from introducing an FTT as it will harm liquidity and undermine other positive market reforms.

4. Laws and Regulation

- Increase regulatory transparency and consistency by a more open market consultation process, providing sufficient notifications of new rules and allowing public comments.
- Improve transparency and reliability of auditing and accounting standards to increase confidence by international investors in China's corporate governance.
- Improve the corporate resolution and bankruptcy process to allow investors to predict the impact of defaults by, among other things, ensuring the enforceability of all investor's direct security interest, if any, in a fair, transparent and clear manner in a restructuring or bankruptcy.
- Implement a resolution and recovery regime for financial institutions that is consistent with the Financial Stability Board's Key Attributes of Effective Resolution Regimes for Financial Institutions.
- Incorporate clearly and unambiguously the enforceability of close-out netting in statute, reflecting internationally accepted practices.
- Amend the Securities Law to support the exchange of variation margin used in the international markets and reflecting internationally agreed standards.

5. Market Infrastructure

- Create statutory provisions for settlement finality on transactions with CCPs and transactions across financial infrastructures in the Bankruptcy Law reflecting international standards enumerated in the CPMI-IOSCO – Principles for financial market infrastructures.
- Allow the clearing member to create a security interest over cash in the margin account which is recognised by China's Property Law or Securities Law.
- Prioritise the application of SHCH to be recognised as an equivalent CCP under EMIR and as an exempt DCO by the CFTC.
- Provide foreign investors the option to use omnibus accounts to allow them to benefit from cost saving and efficiency they currently enjoy from other developed markets. This would allow a simplification in their operating model and improve time-to-market for new products by avoiding the need to open segregated accounts in the entire chain.
- Ensure that the domestic market infrastructure is compatible with international standards, including the PFMI, in order to expand the use of the RMB as an international currency.
- Settlement of the RMB on a PVP basis in central bank money accounts with multilateral netting would support the continued, stable expansion in the global use of the RMB for trade, investment and as a reserve currency, and meet internationally agreed standards.
- Allow third party custodians to hold initial margin on behalf of the posting counterparty.

6. Market Access

- Remove the foreign ownership cap for securities, trusts, asset management, and credit ratings entities.



- Harmonize the requirements of similar access programmes with a view towards future consolidation and/or alignment to improve efficiencies.
- Provide a level playing field by allowing international banks and financial institutions to acquire underwriting licenses on a fair and transparent basis.
- Remove all repatriation limits and quotas across all access programmes.
- Amend the rules on Stock Connect to allow affiliates of Exchange Participants, such as asset managers and custodians, to engage in stock borrowing and lending, and to permit block trades under Stock Connect.
- Improve the transparency and efficiency of the Northbound fund approval process under the MRF.
- Allow foreign investors in China's bond markets to hedge onshore.
- Increase the range of issuers (besides just the sovereigns and quasi-sovereigns) for panda bonds, allow international CRAs to rate panda bonds and allow flexibility in accounting rules in line with global standards (particularly for US GAAP).
- Allow international CRAs to operate without restrictions and promote regulatory environments that are consistent with the international standards set forth by IOSCO's code of conduct.
- Allow foreign investments into an onshore trust holding for securitised assets.
- Clarify the withholding tax on bond interest and place a mechanism for tax to be withheld by the relevant clearing houses on a cash basis and for treaty benefit claims.
- Enter into a Model 1 IGA with the US to comply with FATCA and have the SAT release the CRS final legislation, FAQ and maintain an ongoing dialogue with the financial industry.
- Adopt a flexible interpretation of the Cybersecurity Law at the implementation level for the financial industry.



K. ASIFMA's Accessing Mainland China's Onshore Bond Market

Survey

Overview

The below are the top 10 concerns from the ASIFMA global survey on investors' interest in Mainland China's onshore bond market. The survey queried investors (both existing and potential) about their views on accessing Mainland China bond markets, their primary concerns and what they would like to see changed and developed from a policy perspective.

Participants were asked questions about the importance of a number of topical concerns that they are facing when considering investment in China's onshore bond market: (i) macro-economic factors, (ii) capital market development, (iii) credit information, and (iv) legal and operational concerns. The survey was conducted online between 14 September to 7 October 2016 and feedback was collected from over 100 respondents worldwide, representing a total estimated global AUM of over USD 21 trillion.

The below top 10 concerns are in order from the most to least important issue and the page it appears. The full report is available on ASIFMA's website <http://www.asifma.org/Research/> or by clicking the link [here](#).

Top 10 concerns from survey

1. Free repatriation of invested funds

- Covered in the Market Access section 4b. Remittance and repatriation – pg. 70

2. Clear beneficial ownership rules

- Covered in the Market Access section 6b. Legal, regulatory and operational implications – pg. 74

3. Clarity on withholding tax and VAT regime

Withholding tax

- Covered the Market Access section 12a. Withholding tax treatment – pg. 82

VAT regime

- Covered in the Fixed Income section 16. Efficient tax environment – pg. 45

4. Clear and stable government policy on financial markets

- Covered in the Introduction section – pg. 12

5. Free flow of capital cross-border

- Covered in the Market Access section 1. the Foreign ownership limitation – pg. 68

6. Recognition of close-out netting and clear bankruptcy default mechanism

- Covered in the Laws and Regulations section 4. Creditors rights and close-out netting – pg. 58



7. Freedom to use trading and settlement infrastructure that is integrated with global markets

- Covered in the Fixed Income section 10. Price discovery, trading and clearing and settlement – pg. 38

8. International settlement cycle

- Covered in the Equities section 4. Settlement of trades – pg. 25

9. Availability of hedging instruments such as access to onshore FX products, futures CDS and IRS markets

- Covered the Market Access section 8c. Hedging onshore – pg. 77

10. Corporate governance

- Covered in the Laws and Regulation section 2. Corporate governance – pg. 57

L. Glossary

Term	Definition
ABNs	Asset Backed Notes
ABS	Asset Backed Securities
ABSP	Asset Backed Specific Plan
ADB	Asian Development Bank
AET	Automatic Early Termination
ATSS	Alternative Trading Systems
BIS	Bank for International Settlements
BIS	Bank for International Settlements
BT	Business Tax
CAA	Competent Authority Agreement
Catalogue	Green bond Endorsed Project Catalogue
CAS	Credit Asset Securitisation
CBBCs	Callable Bull/Bear Contracts
CBNs	Central Banknotes
CBRC	China Banking Regulatory Commission
CCDC	China Central Depository & Clearing Co.
CCDC	China Central Depository & Clearing Co., Ltd.
CCPs	Central Counterparties
CDS	Credit Default Swaps
CFETS	China Foreign Exchange Trade System
CFEX	China Financial Futures Exchange
CFTC	Commodities Futures Clearing Commission
CIBM	Chinese Interbank Bond Market
CIRC	China Insurance Regulatory Commission
Classic repo market	Classic Bond Repurchase Market
CLN	Credit-Linked Notes
CLO	Collateralised Loan Obligation
CLOB	Central Limit Order Book
CNAPS	China National Advanced Payment System
CNH	Offshore RMB
CNY	Onshore RMB
CP	Commercial Paper
CRA	Credit Rating Agencies
CRD IV	Revised Capital Directive
CRMA	Credit Risk Mitigation Agreements
CRMW	Credit Risk Mitigation Warrants
CRS	Common Reporting Standard
CSD	Central Securities Depositories
CSDCC	China Securities Depository and Clearing Corporation
CSRC	China Securities Regulatory Commission

CTT	Currency Transaction Tax
DCO	Derivative Clearing Organisation
DVP	Delivery Versus Payment
EMIR	European Market Infrastructure Regulation
Eps	Exchange Participants
ETDs	Exchange-Traded Derivatives
FATCA	Foreign Account Tax Compliance Act
FATF	Financial Action Task Force
FDAP	Fixed, Determinable, Annual or Periodical Income Payments
FIX	Financial Information Exchange Protocol
FMI	Financial Market Infrastructures
FTAs	Free Trade Accounts
FTTs	Financial Transaction Taxes
FTZ	Free Trade Zone
GC	Global Custodians
G-SIBs	Globally Systemically Important Banks
ICSD	International Central Securities Depository
IGA	Intergovernmental Agreement
IMF	International Monetary Fund
IRS	Interest Rate Swap
IRS	Internal Revenue Service
ISIN	International Securities Instrument Number
JV	Joint Ventures
Key Attributes	Financial Stability Board's Key Attributes of Effective Resolution Regimes for Financial Institutions
LC	Local Custodians
LGFVs	Local Government Financing Vehicles
MOF	Ministry of Finance
MTFs	Multilateral Trading Facilities
MTNs	Medium-term Notes
NAMFII	National Association of Financial Market Institutional Investors
NCD	Negotiable Certificates of Deposit
NDRC	National Development and Reform Commission
NPFFIs	Non-participating Foreign Financial Institutions
NPLs	Non-performing Loans
OTC	Over-the-counter
PBOC	People's Bank of China
PFMI	Principles for Financial Market Infrastructures
PvP	Non-payment-versus-payment
QCCP	Qualified CCP
QFII	Qualified Foreign Institutional Investors
RMB	Renminbi
RQFII	Renminbi Qualified Foreign Institutional Investors



SAFE	State Administration of Foreign Exchange
SAT	State Administration of Taxation
SBL	Stock Borrowing and Lending
SCP	Short Commercial Paper
SDR	Special Drawing Rights
SHCH	Shanghai Clearing House
SHIBOR	Shanghai Interbank Bond Offered Rate
SMEs	Small and Medium-sized Enterprises
SOEs	State-owned enterprises
SSE	Shanghai Stock Exchange
STT	Securities Transaction Tax
SZSE	Shenzhen Stock Exchange
VAT	Value Added Tax System
WFOE	Wholly Foreign Owned Enterprises



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