



FINANCIAL SERVICES

China's Capital Markets

The changing landscape

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Introduction



Simon Gleave
Partner in Charge
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At the time of our last capital markets report in 2007, China was riding an unprecedented bull market. Since then, stock markets have been destabilised by the global financial crisis and equity valuations have still yet to recover to the peaks of that time.

Nevertheless, in absolute size China's equities markets have now grown to a significant level, from USD 400 billion in 2005, to USD 4 trillion in 2010. This growth has been fuelled by more than 500 initial public offerings, including the listings of China's largest banks. Shanghai now has some of the world's largest companies represented on its bourse.

As the global financial crisis is consigned to history, longer term factors are now coming into play. With pricing remaining a concern, and few large unlisted companies left to sustain the IPO boom, attention is turning to China's plans for capital account liberalisation and the potential implications for the future development of equities, bonds and derivative products.

Over the past three years several new products and innovations have been introduced and the market response has in many cases been dramatic. We can see that when the government and regulatory authorities act, things can happen quickly and any would-be investor needs to be committed and ready to act to take advantage of the opening up of different asset classes.

A lot has changed, but China is still a young market with huge potential for further growth in all asset classes.



Donald Keith
Deputy CEO
FTSE Group

Executive summary

China's total stock market capitalisation has risen more than tenfold in the past six years to USD 4.2 trillion at the end of Q1 2011. While preparations for the long-awaited International Board are underway, the formal introduction of ChiNext and of Stock Index Futures has broadened the market for both domestic and overseas investors.

The equity market has been evolving and growing towards a more even mix of investor classes, with institutions such as investment funds, pension funds, insurance companies, corporates, sovereign wealth funds and Qualified Foreign Institutional Investors (QFIIs) playing a more prominent role.

Despite their relatively small market share, QFIIs are increasingly important in China's equity market in terms of enhancing fundamental research and market sophistication. As the QFII pool keeps growing, the total quota is expected to expand to USD 30 billion before long.

The recent development of offshore renminbi business in Hong Kong marks the beginning of a new stage in the promotion and internationalisation of the Chinese currency in offshore markets. While Shanghai looks set to emerge as a global financial centre in its own right, the financial cooperation between Hong Kong and Shanghai will continue to strengthen through further cross-border investments and dual / cross-listing of shares, ETFs and other securities in both markets.

Although China's corporate sector remains highly dependent on bank financing, there is growing interest in corporate bonds. We expect this growth to continue, particularly if there is further tightening of the bank and regulatory environment.

While many financial products are in their infancy, the growth in the market for stock index futures shows the level of pent-up demand and how new products can emerge and soak up demand once approved and successfully launched.

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Equity markets



By the end of Q1 2011, the combined market capitalisation of China's Shanghai and Shenzhen bourses surpassed USD 4.2 trillion¹, a significant rise compared to USD 400 billion in July 2005. Combined, these bourses have surpassed the Tokyo Stock Exchange, which stood at USD 3.6 trillion at the same quarter end. More than 2,000 companies are now listed on the Shanghai or Shenzhen stock exchanges.

However, the period since 2005 has been far from smooth sailing. If anything, China's equity markets have been characterised by far greater volatility in these years, than in the preceding decade and a half. Price swings have shown a relatively low correlation to the overall performance of the economy and leading corporations, whose earnings have remained healthy. Having recorded dramatic gains in 2006 and 2007, the markets turned bearish in 2008 and are still to recover to their 2007 peaks.

While the overall impact on China from the global financial crisis (GFC) was short lived, there was a sustained slide in the market for China equities, which only ended in October 2008. The market continued to fluctuate from then until the first quarter of 2011, with overall performance weak despite far higher levels of turnover.

Table 1: Number of listed entities at the end of 2010

Securities	Type	Shanghai	Shenzhen	Total
Shares	A Shares	895	473	1,368
	B Shares	54	54	108
	Small and Medium Enterprise Board*	0	531	531
	ChiNext*	0	153	153
Bonds		505	191	696
Investment Funds		13	93	106
Hong Kong	H Shares	163		
	Red Chips	102		
	Non-H Share Mainland Private Enterprises	327		

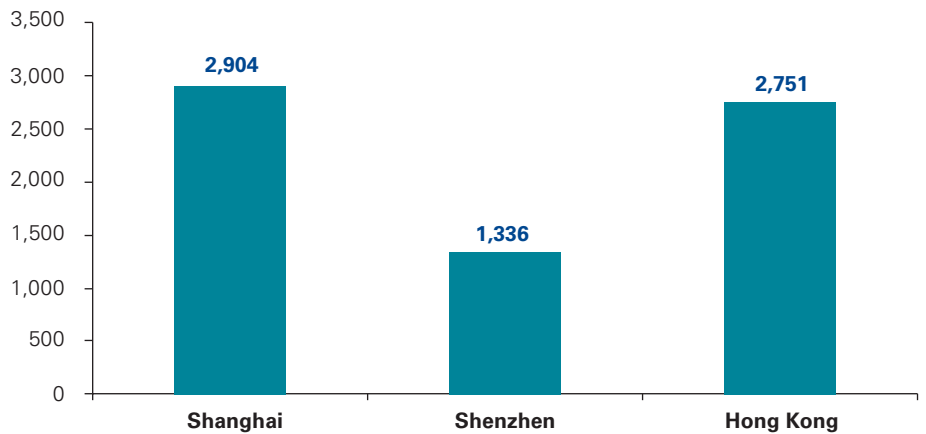
Source: Stirling Finance Limited.

* Please refer to the rest of this report for details.

¹ Source: World Federation of Exchanges.

A Shares continue to play the central role in China's stock market story. These renminbi (RMB)-denominated shares, which can only be traded by mainland Chinese nationals and Qualified Foreign Institutional Investors (QFIs), continue to overshadow the much smaller foreign currency B Share market, which is available to domestic retail investors with access to foreign currency, as well as to foreigners. Having been eclipsed by the introduction of QFIs, the role of B Shares appears to have diminished further since the GFC and there is continued market speculation on a future merger of the A and B Share markets.

Graph 1: Market Capitalisation of China's Stock Exchanges (USD, billion)

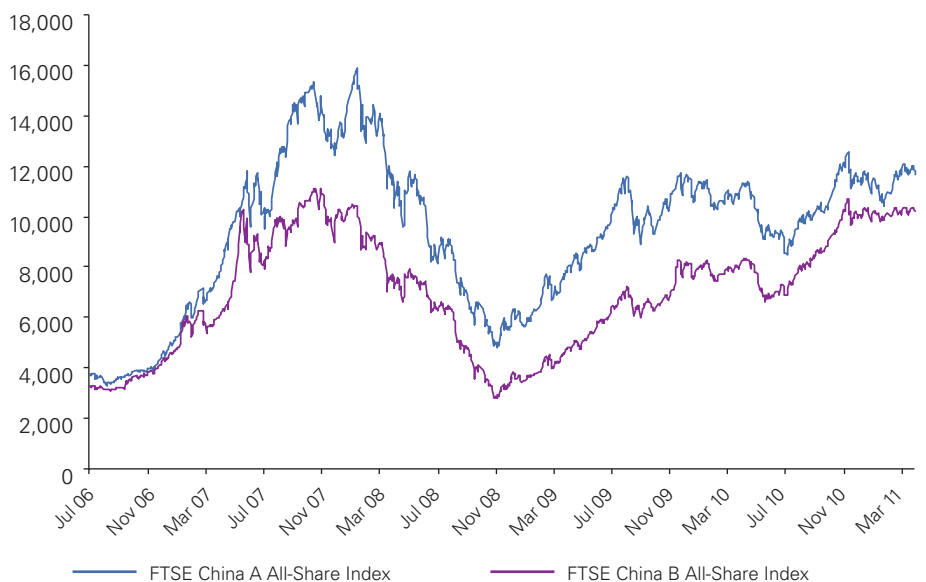


Source: FTSE, Stirling Finance Limited, as at end March 2011.

The FTSE China A All-Share Index, which gauges China's A Share market, surged 324 percent from July 2006 to October 2007, while the FTSE China B All-Share Index, a measure of the B Share market, rose by a less impressive 237 percent over that period. On average, A Shares traded at a P/E ratio of 18 as at the end of 2010, a healthy figure compared to 48 at the A Share market's peak in 2007.

This also compares favourably with the current P/E ratio of 42 for the listings on the SME Board in Shenzhen. The SME Board is a special board for small and medium-sized companies which wish to raise capital. Launched in 2004, it had 531 listed companies as at the end of 2010. Though the Board has brought many small companies to market, it has had a bumpy ride since 2006. Slightly lagging behind the A Share market, the SME market peaked in January 2008 before dropping to a low point in November 2008. Since then, there has been a steady recovery.

Graph 2: FTSE China A All-Share Index and FTSE China B All-Share Index (USD, Total Return)



Source: FTSE Group, data as at the end of March 2011.

Many important A Share companies are also listed on the Hong Kong Stock Exchange (HKEx), as H Shares. Besides H-Shares, other China-related companies listed in Hong Kong include Red Chips, companies incorporated in Hong Kong, which have at least 30 percent of their equity held directly or indirectly by mainland Chinese entities, and at least 50 percent of their sales revenue or operating assets derived from mainland China. H Shares traditionally traded at a discount to their A Share counterparts, but since 2007 there has been a dramatic narrowing in the A-H premium due to the relative underperformance of A Shares.

The changing investor landscape

China's equity markets are evolving towards a more even mix of investor classes. In some respects, institutional investors have now taken over from retail investors as the major force driving equity markets. The role of both domestic and foreign institutions is growing, as investment funds, pension funds, insurance companies, corporates, sovereign wealth funds (SWFs) and QFIIs all look to increase their allocations to Chinese equities.

KPMG comment

The number of investment funds in China has grown substantially, with many managers partly owned by international firms. We see this as a positive indication of the maturing of China's capital markets and expect the growth of investment funds to continue in the coming decade.

Nevertheless, retail investors continue to represent a sizable portion of the market. Total household savings in China hit RMB 31 trillion at the end of 2010, much of which has shifted between savings and stocks plus mutual funds. At the end of 2010, institutions held total savings of RMB 25 trillion. They conduct around 40 percent of the trading by volume and own about 60 percent of China's tradable shares by value.² As retail investors tend to follow the investment trends of institutional investors, any significant movement by institutional investors still has the potential to trigger volatility in the market.

At the beginning of 2011, 60 fund houses were managing a total of 707 mutual funds authorised by the China Securities Regulatory Commission (CSRC), with total assets hitting RMB 2.4 trillion for open-ended funds and RMB 1.4 trillion for close-ended funds.³ Equity funds and balanced funds accounted for 55 percent and 20 percent of the open-ended fund universe respectively, with bond funds and fund-of-funds taking much of the remaining 25 percent.

In addition to retail fund business, segregated account business mandated by high-end individuals and corporations with special investment requirements have become more prevalent since 2007. The total fund size for segregated accounts reached RMB 60 billion in December 2010, and the 10 best performing accounts managed to reward their investors with a return of 24 percent for the year.⁴

Insurance companies have also built up assets at a fast pace, reaching RMB 4.9 trillion at the end of 2010.⁵ Up to 20 percent of these assets can be invested in equities and equity funds. In general, insurers have been quite active and, given the nature of their business, inclined towards long-term, stable investment opportunities.

The total assets of China's supplemental pensions (enterprise annuities) also increased to RMB 300 billion at the end of 2010,⁶ and under current regulations up to 30 percent of this amount can be invested in equities.

Private equity (PE) funds have also taken strong equity positions in China, perhaps partly because of the difficulties they face in obtaining controlling stakes in target companies. At the end of 2010, the number of active PE funds exceeded 600 with total assets of RMB 10 billion under the management of 300 managers. Statistics show over two-thirds of those funds, however, have at least half of their assets allocated into the stock market and some 10 percent of the funds held more than 90 percent of their assets in stocks. The existing 286 PE funds yielded an average return of 10.6 percent in 2010.⁷

² China Securities Depository and Clearing Corporation Limited.

³ Wind, CMS China Research Department.

⁴ www.simuwang.com

⁵ Data released by CIRC (China Insurance Regulatory Commission).

⁶ Data released by MoHRSS (Ministry of Human Resources and Social Security).

⁷ Data released by PE Fund Data Center, CBN Research.

The role of QFII

The Chinese government introduced the Qualified Foreign Institutional Investor (QFII) system in 2002 to permit overseas institutional investors to buy into domestic-listed equity and debt markets. Prior to this, foreign investors were only allowed to invest through the B-Share market. As a gateway into the domestic market, the system currently allows more than 100 international institutions comprising banks, trust companies, insurers, asset managers, securities firms, sovereign wealth funds, pension funds and endowment funds to invest in China's securities markets. It is understood that another 100 or more applicants are waiting for approval.

At the end of 2010, the total quota approved by the State Administration of Foreign Exchange (SAFE) had reached USD 19.7 billion, and the government has pledged to expand the quota to an eventual total of USD 30 billion.

In terms of actual investment, QFII funds traditionally implement a relatively stable and high equity allocation strategy. Under normal circumstances, QFII positions are maintained at levels of 70 to 90 percent in A Shares. With regard to actual investment performance, QFIIs in general underperformed as a whole — though at the same time, slightly less volatility was also evident. The average annual return on QFII funds for the past 4 years was 124 percent, -65 percent, 78 percent and -11 percent respectively, compared to 163 percent, -64 percent, 103 percent, -4 percent for the benchmark FTSE China A All-Share Index over the same period.

The market share of QFIIs has been increasing since the beginning of 2011 due to quota holders' optimistic view of the A-Share market. Though QFII holdings still only account for less than 2 percent of total stock market holdings, their influence far outweighs their relative size. They are watched closely by many domestic investors due to the depth of their fundamental research and relatively sophisticated approach to risk management and selection.

Shanghai International Board

Overseas companies are not yet able to list directly in China, although several have expressed a desire to be among the first to list on Shanghai's proposed International Board.

Before launching the International Board, China's regulators need to formulate listing rules and market regulations addressing the preparation of financial statements, management discussion and analysis, and audit requirements. The following are some of the key points to be clarified:

- **Accounting Standards approach:** In particular, will non-Chinese entities need to use Chinese GAAP; will a reconciliation approach be required if other GAAP are accepted, and how do Chinese market regulators plan to enforce the interpretations of IFRS if IFRS are accepted?
- **The role of non-Chinese audit firms:** Will the regulators establish criteria for non-Chinese accounting firms to audit non-Chinese companies listing in the PRC?
- **Disclosures, management discussion and analysis:** For example, will non-Chinese entities be required to meet the same disclosure requirements as domestic listed entities and be subject to the same review methodology on their IPO prospectuses? Will Chinese language prospectus and disclosures be required?

Once the rules for an International Board are released, we expect to see a number of companies seeking to tap the liquidity of China's savings market through local listing. As these issues are clarified, there could be many implications to non-Chinese entities looking to raise capital on China's equity markets.

Capital in, capital out: Sovereign Wealth Funds (SWFs)

In terms of the impact on China's domestic stock markets, two SWFs, namely the National Social Security Fund (NSSF) and China Investment Corporation (CIC) also play a significant role.

The NSSF was set up in 2000 as a 'fund of last resort' to help meet China's future pension challenge. It has been growing significantly in size, stature and influence since its inception with total assets rising from the initial RMB 20 billion (USD 3.1 billion) to RMB 857 billion (USD 131 billion) by the end of 2010.⁸ This makes it by far the biggest institutional investor in China's pension sector. In terms of investments, the NSSF must deploy no less than 50 percent in domestic bank deposits and government bonds via direct investment, but significantly it can also invest up to 30 percent of its total assets through appointed fund managers in domestic stock markets.

The NSSF also has fixed income holdings and investments in PE funds and has benefitted by receiving a proportion (typically 10 percent) of the proceeds of certain state-owned enterprise IPOs. Domestic holdings have increased significantly, especially after the GFC when most domestic equities were trading at historically low levels. This not only reflects the Fund's long-term investment objective, but also indicates an important role for the Fund – serving as a strong stabilising force in the domestic market.

CIC has helped to diversify the country's massive reserves and generate strong returns via long-term investments. With nearly two-thirds of its initial capital of USD 200 billion allocated domestically, CIC holds significant stakes in key national banks and financial institutions on behalf of the government. Such holdings include 49 percent of China Development Bank, 35 percent of Industrial and Commercial Bank of China, 50 percent of Agricultural Bank of China, 68 percent of Bank of China and 57 percent of China Construction Bank.⁹ These holdings, combined with the profits generated by its other domestic and overseas investments, brought the total asset size of CIC to almost USD 400 billion by the end of 2010 with the average return on assets over 12 percent per annum.¹⁰

Capital outflow – QDII

While the QFII scheme allows for international capital inflow into mainland financial markets, the Qualified Domestic Institutional Investor (QDII) programme introduced in April 2006 sanctions five types of Chinese entities to invest abroad — banks, trust companies, fund houses, securities firms and insurance companies. These entities can make investments in fixed income, equities and derivatives in approved overseas markets, both for themselves and on behalf of retail or other clients. Approval for both a licence and quota is required from the respective regulator and from SAFE respectively. As at end 2010, 95 Chinese institutions had been granted QDII status, with a total quota of USD 68.4 billion being allocated among 88 of them.¹¹

The QDII market provides more investment channels to Chinese retail and institutional investors. In doing so it helps domestic investors diversify market risk and, by reducing excessive internal liquidity, eases the pressure on the RMB to appreciate. In these respects, the QDII market has also impacted the capital market domestically, by providing alternative investment options and dampening currency speculation.

Following the launch of a number of mega-funds in 2007, the QDII market was relatively quiet in 2008 and 2009 before picking up again since December 2009. There are signs of a maturing of the domestic fund houses as many of them seek to develop their in-house QDII research teams. Over time, international participants' bridging role may diminish. It is no longer the case that the QDII managers will simply look for special QDII services that an international partner claims to offer; more importantly, they are starting to eye the potential opportunities for their global expansion through partnerships with these international houses.

KPMG comment

QFIIs serve as an intermediary subject to control and measurement of capital flows into and out of China. As the capital account liberalises, QFIIs will continue to be a major conduit for foreign investment, but we expect the quota system will be relaxed in some ways.

⁸ NSSF 2010 Annual Report

⁹ CIC 2009 Annual Report. These are not traded on the secondary market.

¹⁰ As per CIC public disclosure reported by Chinese media.

¹¹ Source: SAFE.

Recent innovations

Three recent developments which have contributed to the development of a more mature equities environment are the secondary ChiNext market in Shenzhen, the launch of stock exchange futures and the allowing of QFII investors to participate in futures trading.

ChiNext for start-ups

Established on the Shenzhen Stock Exchange (SZSE) in October 2009, ChiNext was set up to list companies in high growth sectors such as technology and pharmaceuticals. While requiring a far lower level of capital than the Main Board or the SME Board, ChiNext has stricter thresholds in other areas (such as for business operations, information disclosure and limitations on stock sales) in place for transparency and risk management purposes.

ChiNext is considered an important capital market instrument to broaden China's industrial structure and promote economic reform, especially given the difficulties some start-ups still face in securing bank financing. At the end of 2010, 153 companies had successfully listed on ChiNext, with a total market capitalisation of RMB 737 billion, including RMB 117 billion raised from the public. The average P/E ratio on ChiNext reached 60, signaling investors' enthusiasm for the new board.¹²

Launch of long-awaited stock index futures

China finally granted investors access to stock index futures in April 2010, subsequent to the official introduction of margin trading and short selling. Investors are now able to profit from both gains and declines in the market through more sophisticated investment instruments. Despite high levels of interest from retail investors and need for a relatively low capital entry requirement, a relatively stringent set of rules was imposed including a threshold of RMB 500,000 as the minimum deposit for a single trading account and a margin requirement of 12 percent. Eligible retail investors must also have prior experience with commodities futures trading or mock trading of index futures, reflecting the regulators' cautious attitude while gradually opening up the new channel for local investors. Equity funds, balanced funds and capital preservation funds are now allowed to participate as well, though bond funds or money market funds will need to wait for further notice.

¹² Wind, CMS China Research Department.



The first and the only stock index future is based on the CSI 300 Index, which covers about one-sixth of all stocks listed in China and accounts for about 60 percent of market capitalisation. There are currently four active contracts for the front month, one month behind the front month, and then the next two months in the March, June, September, December cycle. The future is also subject to a +/- 10 percent price band based on the previous close. At the end of 2010, 46 million contracts had been traded, and average daily volumes had stabilised at around 250,000 spot contracts (with approximately USD 38 billion notional equivalent).

The index futures market has generated huge interest from retail investors. By the third day of trading, the traded value of stock index futures already exceeded the value of stocks traded on the SSE. Though the CSRC has imposed strict instructions for proper regulation of the market, it is clear that the market is highly influenced by speculation, which has heightened volatility and limited its ability to truly reflect the direction of the underlying stock market. Further developments are taking place towards a mature index futures market, and liquidity should continue to increase.

QFIIs allowed to participate in stock index futures trading

As part of the government's efforts to further open up China's financial markets, the recently unveiled "Rules on Index Futures Trading for Qualified Foreign Institutional Investors (QFIIs)" allow for QFIIs' participation in the domestic stock index futures market by offering them a new hedging tool, a further investment option and a level playing field with domestic investors.

Stringent limits set out in the Rules, however, are indicative of the government's caution regarding the nascent financial derivatives market. As retail investors have always regarded investments by QFIIs as an indicator of sensible diversification in the A-Share market, QFIIs' participation in the stock index futures market could prove influential. With their index trading experience gained in the international markets, QFIIs could help broaden the investor base of China's financial markets.

Regulatory changes

China's regulatory bodies (most notably the CSRC) are playing a critical role in the changing composition of the investor base and in allowing specific production innovations. With so much pent-up demand for new financial products, when the government and regulators act, the market can often respond extremely quickly.

Prospects for a new Fund Law

In order to improve market transparency, China is moving closer to revising the current law governing the fund management business by circulating a consultation paper within the industry. A new Fund Law may involve several amendments to the current legislation which was promulgated in 2003. This may include allowing fund managers to trade equities and derivatives for personal accounts, something which is currently prohibited in China.

The government continues to explore how deregulation can enhance the market without increasing the risk of insider trading. The CSRC has indicated that it may expand the supervision of fund managers and include on-site investigation of fund managers.

Other significant developments include proposed regulation of non-public funds by the CSRC, granting non-public funds access to the public retail fund market. By registering with the CSRC, non-public fund managers may offer public funds subject to approval. This may lead to further market competition with public fund managers due to the expertise and service non-public fund managers can offer, especially in wealth management business.

KPMG comment

Stock index futures are a sign of the maturation of capital markets although some stringent rules are attached. QFIIs will be allowed to trade stock index futures for hedging, but not for speculative purposes, in a similar manner to their domestic counterparts. QFIIs are also prohibited from issuing financial derivative products in offshore markets with index futures as an instrument, are limited in the daily value of futures contracts they can hold, and can only open accounts with one bank for custodian services and no more than three futures brokerages for futures trading.

Investment rules relaxed for insurers

In August 2010, a set of new investment guidelines was promulgated by the CIRC, aiming to broaden the investment scope for the insurance industry in the country and help improve the asset-liability matching ability of the insurance companies.

The new rules took effect on 31 August 2010 with key highlights including a minimum requirement of 5 percent of total assets for bank deposits, government bonds/securities and money market funds and a maximum holding of 20 percent for equities and equity funds (instead of mutual funds only as in previous regulations). Policy relaxations were also granted for investment in other asset classes such as private equity, infrastructure and real estate. In general, the new guidelines are widely considered as a positive development for the insurers as more investment channels are now open. The insurance industry had total assets of RMB 4.9 trillion as at the end of 2010, which means a maximum of almost RMB 1 trillion can be allocated to equities. This equates to 4 percent of total stock market capitalisation at present.

Offshore developments

The deregulation of offshore RMB business since mid-2010 has led to fast-paced development of an offshore RMB market in Hong Kong. The launch of the first RMB fund and RMB-denominated insurance policies granted foreign investors new investment channels to access RMB-denominated assets. It also served as an example of further promotion and internationalisation of the Chinese currency in offshore markets.

While Hong Kong remains the leading centre for large Chinese initial public offerings, the continued growth of the Shanghai Stock Exchange (SSE) in the past five years means that by the end of 2010, the total market capitalisations of Shanghai and Hong Kong were very evenly matched. With effect from December 2010, the HKEx has allowed Chinese companies to submit their accounts using Chinese accounting standards. While the HKEx has presented the move as a way to help reduce compliance costs for mainland companies and improve market efficiency, the new PRC accounting standards, which were released on 1 January 2007, are already quite closely aligned to International Financial Reporting Standards (IFRS).

Shanghai's plans for an International Board will certainly be well received by foreign companies and local investors alike upon its formal introduction. In the meantime, Chinese companies will also benefit from expanded listing choices. The first RMB-denominated share has just been listed on HKEx. Such dual/cross-listings should eventually help raise the overall quality of listed companies in both Shanghai and Hong Kong and effectively expand the breadth and depth of both markets.

Further capital inflow: Mini-QFII

The forthcoming Mini-QFII programme looks set to serve as an additional inward capital channel. As a variation on the original QFII scheme, Mini-QFII will allow qualified Hong Kong subsidiaries of both Chinese securities firms and fund management companies to channel RMB deposits in Hong Kong into the mainland financial markets via investment products.

The programme will also be supervised by the CSRC and will distinguish itself from the original QFII in terms of currency and possibly investment scope. It will be subject to separate licence and quota approvals as indicated in Table 2.

With a number of Chinese firms' Hong Kong subsidiaries actively preparing licence applications, market expectations point towards a high probability that the mini-QFII assets will be initially invested in fixed income products, with equity investment exposure being relaxed on a gradual basis.

The market generally expects the initial size of the programme to be RMB 3 billion, which would equate to about 10 percent of the total QFII quota pledged. This

Table 2: QFII vs. Mini-QFII

	QFII	Mini-QFII
Qualified candidates	Foreign securities firms	HK subsidiaries of Chinese securities firms
	Foreign fund managers	HK subsidiaries of Chinese fund managers
	Foreign banks	
	Foreign insurers	
	Others, e.g. pension funds, SWFs, etc.	
Currency	Foreign currency from foreign countries converted into RMB via Chinese custodian banks	RMB from HK only; no currency conversion is involved
Quota	Eventually USD 30 billion	Market expectation: USD 3 billion
Investment scope	Listed stocks	To be confirmed
	Listed bonds	
	Investment funds (including ETFs)	
	Warrants	

Source: Stirling Finance Limited

would only have a limited impact on the A Share market initially, but the mini-QFII programme will certainly help increase the attractiveness of RMB to offshore investors. Total deposits in Hong Kong reached RMB 510 billion by March 2011, according to Hong Kong Monetary Authority disclosures.

Cross-border listing of ETFs

As an indication of further improved cooperation between the mainland and Hong Kong, the latter has listed 24 exchange-traded funds (ETFs) to track the performance of mainland stock indices. These products are open to both Hong Kong and foreign investors, based on indices such as the FTSE A50 China Index.

The Shanghai and Shenzhen stock exchanges are also planning to list the first cross-border ETF this year as mainland investors continue to seek further asset diversification from local markets. The underlying investments will be a number of companies traded on HKEx.

As the HKEx lists companies with a diverse background, including firms from Hong Kong, mainland China, and the rest of the region as well as other parts of the world, such a cross-listed ETF should provide Chinese investors with a greatly expanded offshore investment horizon. The mainland stock exchanges, however, may start by launching an H-Share ETF first due to greater familiarity with the underlying H-share companies. Harvest Fund Management launched a listed open-end QDII fund (LOF) on the SZSE in October 2009 tracking H Shares listed in Hong Kong; this could be considered as the debut of the pre-ETF phase of cross-border listing.

Case study

The continued role of QFII

William Kwok, Head of QFII, Ping An Securities

Ping An Securities acts as a bridge between QFIIs and the A-Share market and is therefore in a key position to identify the trends and strategies of different quota holders.

"I expect QFII will remain important over the coming five to 10 years," says William Kwok, Head of QFII for Ping An Securities. "We could see QFIIs' share increase from 1 percent of the total market capitalisation to 3 or 5 percent. That would have a limited impact on the domestic market, but it would enhance the stability of the investor base and would be sure to generate more interest internationally."

There are currently about 110 companies which are approved to invest in China A-shares and some of them, including JP Morgan, Morgan Stanley, Deutsche Bank, Manulife Asset Management and UOB Asset Management, have used their quotas to establish QFII funds. Mr. Kwok is aware of at least 50 more organisations lining up for QFII licences. With most of the large investment banks and mutual fund houses already allocated quotas, insurance companies plus banks and fund houses are also getting involved. Several Taiwanese institutions recently obtained licences. Banks from other countries such as South Africa are

seeking approval along with pension funds from Canada, Korea and Australia.

Several Ivy League endowment funds in the US have also obtained quotas. Mr. Kwok is aware of certain private banks that are interested in applying for QFII and he notes that a precedent has been set for these banks to join with the acceptance of Bank Julius Baer & Co. Ltd. Mr. Kwok feels that the pace of approval is likely to remain relatively measured, since applicants must deal first with the CSRC (for the investment licence) and then the SAFE (for the quota approval). It can take up to 18 months from licence application to product approval and quota allocation, although Mr. Kwok notes some applications have passed through more quickly.

As a subsidiary of Ping An Group, Ping An Securities with its brother companies, acts as a broking house provide a trading platform for QFIIs to trade China A Shares. With research capacity and an administrative advisory team it can help through the application process and then leverage its network across China to identify investment opportunities.

With a total quota of USD 20 billion so far approved by SAFE, Mr. Kwok sees

more room to help in the years ahead. "QFIIs have always been seen as pioneers because they have their own research and investment teams guiding stock selection," Mr. Kwok explains. "However the composition of QFIIs is becoming more diverse. We are starting to see more varied approaches to stock selection. Some QFIIs are applying to invest in the ChiNext listings and picking out smaller high-growth-potential stocks."

Looking ahead, Mr. Kwok expects to see more developments which should enhance the depth of the markets. "There is still a lack of tools such as derivatives to manage risks and only a limited choice of ETFs," he explains. "It is really exciting to be involved in the market during this period of economic growth and development."

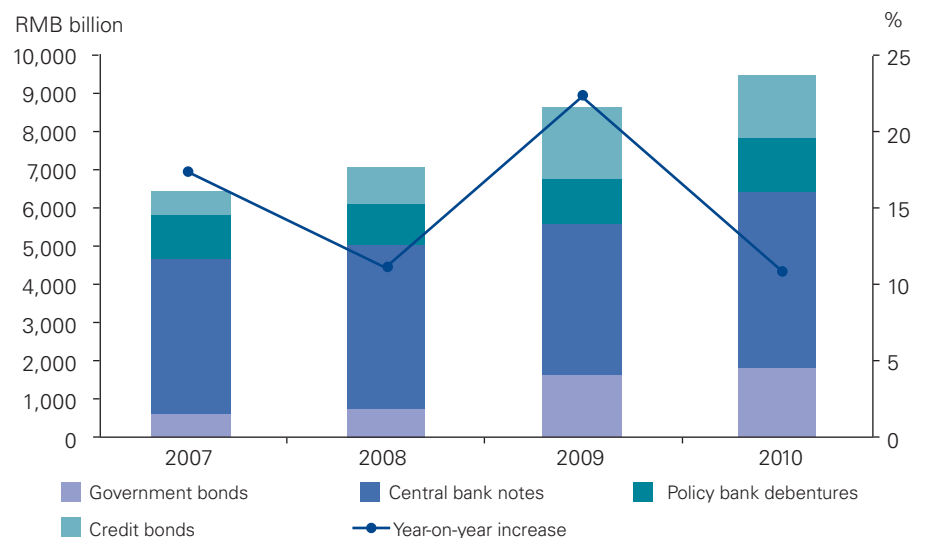
Bond markets



China's bond markets have played an important role in the implementation of national macroeconomic policies, financial sector reforms and more recently the government's economic stimulus measures. However, when compared with other developed markets, the bond market's role in resource allocation remains limited and it has not been able to fulfil the demand created by China's dramatic economic growth. On the one hand, the composition of bond issuers is uneven. More than 80 percent of the depository balance comprises government bonds, central bank notes and financial bonds and there has been a comparatively slow development of credit bonds. On the other hand, the approval and regulatory organisations are still not unified and a market-oriented issuance system has yet to be realised. The constraints for cross-market issuance and trading of bonds prohibit investors from investing and trading cross-market and there is also a lack of a unified and linked settlement system.

In 2010, RMB 9.51 trillion of bonds were issued, of which 98.3 percent came from the inter-bank bond market. Central bank notes, government bonds and policy bank debentures accounted for 82.8 percent of the total issue, down from 92.2 percent in 2007. Excluding central bank notes, government and enterprises have raised a total of RMB 4.85 trillion from the bond markets, of which RMB 3.22 trillion are government and policy bank debentures, and RMB 1.63 trillion are corporate bonds.¹³

Graph 3: Inter-bank bonds issued by category 2007-2010



¹³ China Central Depository & Clearing Co., Ltd.

Source: China Central Depository & Clearing Co., Ltd. Foreign bonds, to the amount of RMB 1 billion, were issued in 2009 only. This amount does not show on the graph

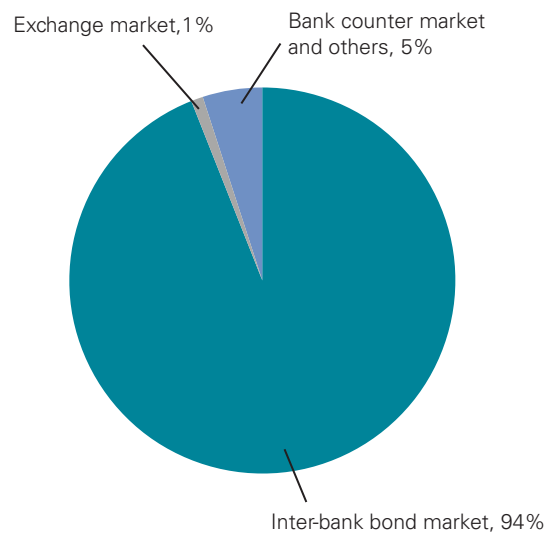
There have been a number of triggers for the growth of the bond markets over the past five years. These include:

- the launch of short term bonds in the inter-bank market in 2005
- the introduction of corporate bonds by the CSRC In 2007
- the launch of medium-term notes by the National Association of Financial Market Institutional Investors in 2008
- the launch of Small and Medium Sized Enterprises Collective Notes in 2009, a particularly positive development in helping small and medium-sized enterprises overcome financing barriers
- the launch of credit risk mitigation instruments and 270-day super and short-term commercial paper in 2010, which further enriched the variety of bonds.

In addition, the denomination of bonds has extended to other currencies besides the RMB. The variety of trading has also diversified from spot transactions and collateralised repos to other types such as outright repo, bond forward transactions, bond loan, interest rate swaps and forward rate agreements.

With commercial banks prohibited from trading in the exchange market since 1997, the exchange and inter-bank markets have become the two main bond markets. The inter-bank bond market accommodates trading of large value transactions with institutional investors as the main participants. The exchange bond market also allows for participation by individual investors and centralises and facilitates transactions in the retail market. The bank counter market is an extension of the inter-bank bond market and also supports the retail market. Most of the bonds traded are unlisted.

Graph 4: Structure of bonds in depository at the end of 2010



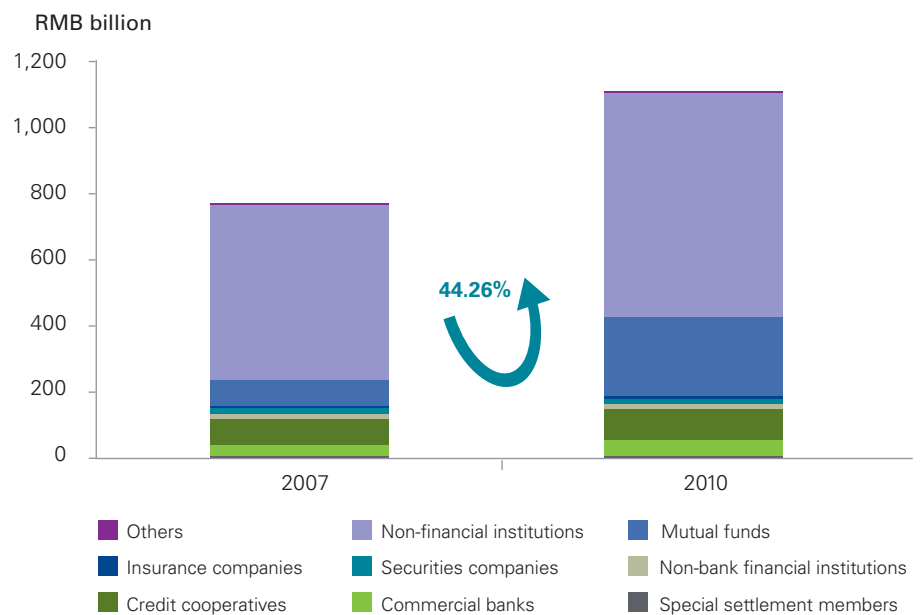
Source: China Central Depository & Clearing Co., Ltd.

The inter-bank bond market continues to be the main platform for allocating capital and conveying monetary policies. At the end of 2010, the total bond depository balance was RMB 20.17 trillion, a 63.6 percent increase compared to 2007. Of this, the inter-bank bond depository balance was RMB 18.88 trillion, an increase of 69.5 percent compared to 2007.¹⁴

The exchange bond market has grown slowly since the first corporate bonds were issued in 2007. At the end of 2010, 90 corporate bonds were issued with a value of RMB 1.46 trillion.¹⁵ The low issuance and market volumes have constrained efficient pricing in the secondary market and hindered growth, causing the exchange bond market to fall further behind the inter-bank bond market in terms of issue size and the depository balance. Given the need for some stimulus to the market, the CSRC, The People's Bank of China (PBOC) and the China Banking Regulatory Commission (CBRC) promoted the pilot participation of commercial banks in the trading of bonds in stock exchanges in 2009. On 30 September 2010, CSRC issued "Notice of pilot participation of listed commercial banks in bond trading on stock exchanges," which allows commercial banks to take advantage of the strengths of the exchange and inter-bank markets and to optimise their asset allocation.

Major participants of the bond markets

Graph 5: Changes in composition of bond market investors 2007-2010



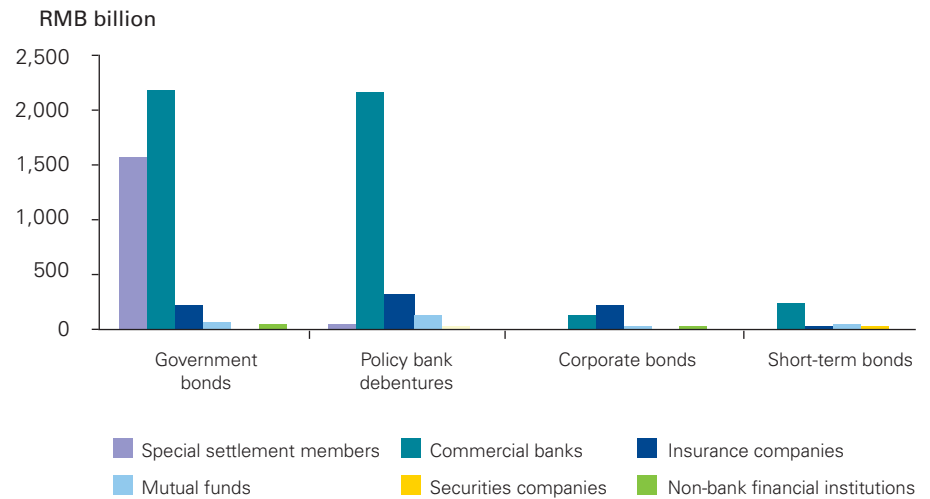
Source: China Central Depository & Clearing Co., Ltd.

Bond market investors are expanding and diversifying their investments. At the end of 2010, there were 10,235 participants in the inter-bank bond market, an increase of 44.3 percent on 2007, while commercial banks remained the major players. Almost 1,000 new participants entered the market in 2010 including 581 mutual funds, 309 enterprises, 54 banks, 26 credit cooperatives, 11 non-bank financial institutions and four insurance companies.¹⁶

Risks in the bond markets are being borne by an increasingly wide range of players including banks, insurance companies, mutual funds, securities companies, individuals and overseas investors. On depository balance, excluding the special settlement members, insurance companies, mutual funds, securities companies and individual investors have increased their balances from 14.9 percent of the total from 2007 to 18.9 percent in 2010.

¹⁵ China Central Depository & Clearing Co., Ltd.
¹⁶ China Central Depository & Clearing Co., Ltd.

Graph 6: Differences in the investment holdings by different bond investors



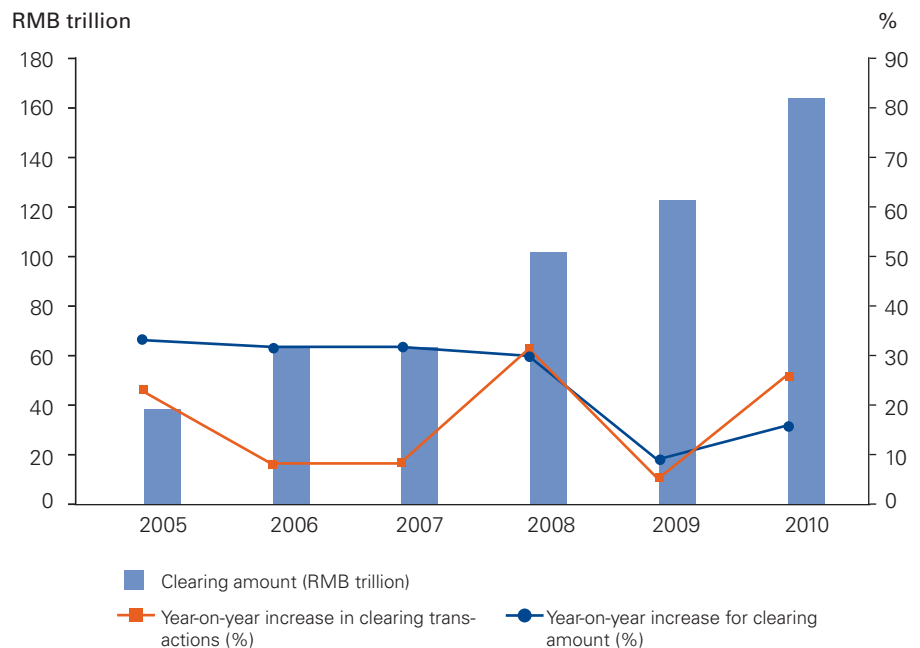
Source: China Central Depository & Clearing Co., Ltd.

KPMG comment

China's corporate sector remains highly dependent on bank finance, but a structural shift is underway. Corporate bonds are a small but fast-growing part of the debt securities market and we expect this growth to continue, particularly if there is further tightening of the bank and regulatory environment.

There are significant differences in the holding of government bonds, policy bank debentures, corporate bonds and short-term bonds by various bond investors. For government bonds, the top three investors (excluding special settlement members) are commercial banks, insurance companies and mutual funds. For policy bank debentures, due to their low-risk high-return nature, commercial banks, insurance companies and mutual funds have a comparatively high proportion of holding. For corporate bonds, insurance companies are the leading investors, followed by commercial banks and mutual funds. Commercial banks are the biggest investor on short-term bonds. Most financial institutions are regulated by rules and regulations on their bond investments, including the investment grade of the bonds that can be invested and the debt to capital ratio. Most of China's bonds are currently rated as medium to high with very few rated low. The mismatch between the supply and demand indirectly affects the holdings of bond investors.

Graph 7: Trading activity



Source: China Central Depository & Clearing Co., Ltd.

Trading in bond markets

The total transactions for China bonds reached RMB 162.81 trillion in 2010, a significant increase of 158 percent compared to RMB 63.13 trillion in 2007.¹⁷ Since 1999, the interest rate on government bonds and policy bank debentures has been set through market tenders. The market maker system was established for China bonds in 2007. The relatively low profitability for market makers in the bond markets has created little impetus for banks to do any more than fulfill their obligations. Moreover, the current business is focused on financial institutions, as the market opportunities are less clear for non-financial institutions and retail markets. The lack of product variety and the limited availability of risk mitigation instruments have also been factors restricting the development of the market maker system.

As the market continues to expand in breadth and depth, a yield curve for the inter-bank bond market has been established and provides a basis for the pricing of financial products in China. Between January and August of 2010, there was a declining trend in the yield curve for long-term bonds. This was followed by a gradual rise from September onwards. Overall, the yield curve on government bonds remained flat throughout the year. There was a rise for the 1- to 3-year bonds and the yield on inter-bank one-year fixed rate government bonds rose by 184 basis points.

Development of the credit rating industry in China

The expansion of China's bond markets and increased diversity of products has led to the development of the credit rating industry in China. With accumulated experience, increased competition and stronger supervision, China's credit rating agencies continue to refine their own structures. This is evidenced by improvements in their compliance, technology, systems, expertise and internationalisation.

There is evidence of credit rating agencies establishing more compliance-oriented systems with improved codes of conduct and supervision in areas relating to professionalism, independence, conflict of interests, information disclosure and transparency. To further support professionalisation of the industry, on 21 October 2010, the Professional Committee of Credit Rating under the National Association of Financial Market Institutional Investors (NAFMII) was founded in Beijing and is the first self-regulated organisation approved by the Bureau of Civil Affairs.

In terms of methodologies and standards, credit rating agencies have established systematic approaches towards qualitative and quantitative analysis. They have learnt from the rating methodologies and techniques used by international rating agencies and applied these to the credit environment in China.

China's rating agencies have made great strides in strengthening international ties. At the end of 2010, several credit rating agencies established joint ventures and other forms of cooperation with their international peers. Several have become members of the Association of Credit Rating Agencies in Asia (ACRAA), applied to certify as international rating agencies, and issued sovereign rating reports. Credit rating agencies in China have seized the post-crisis opportunity to increase their international standing, and have actively participated in the formulation and setting of international credit rating methodologies, rules and standards to stabilise the global financial system together with the international market.

¹⁷ China Central Depository & Clearing Co., Ltd.

Recent innovations

The bond financing instruments available to non-financial corporates have expanded the channels for direct financing, while the roll out of innovative Credit Default Swap (CDS) products have improved the risk-sharing mechanism in the market and increased the proportion of direct financing. As a result, bond markets are starting to play a more prominent role in resource allocation. At the end of 2010, the total balance for debt financing by non-financial corporates amounted to about RMB 3.81 trillion, an increase of 361 percent compared to 2007. Medium-term notes have been especially prominent since their launch in 2008 and have become a primary financing instrument in the inter-bank bond market.

Table 3: Balance debt financing instruments for non-financial corporations in 2010 and 2007

Unit: RMB billion, %

Types of bond	2010		2007		Growth rate (%)
	Amount	Proportion	Amount	Proportion	
Enterprise bonds	1,480.43	38.84	445.5	53.83	232%
Short-term bonds	690.99	18.13	319.61	38.66	116%
Medium-term notes	1,382.10	36.25	-	-	-
Asset-backed securities	14.19	0.37	31.37	3.80	(55%)
Corporate bonds	164.64	4.32	5.2	0.63	3,066%
Convertible bonds	79.63	2.09	25.48	3.08	213%
Total	3,811.97	100.0	826.71	100.0	361%

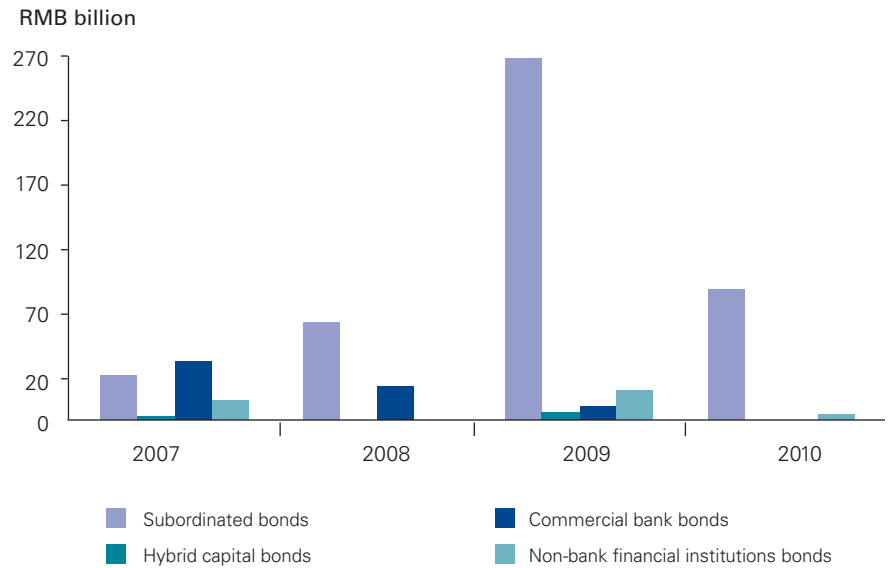
Source: Data from the website of China Central Depository & Clearing Co., Ltd., Wind Information Co., Ltd.

In terms of the types of entities, enterprises that undergo debt financing are often dominated by state-owned entities while the vast majority of private companies and small and medium-sized enterprises have yet to fully implement debt financing in the financial market.

In view of the increasing scale of the credit market, however, China is still in its infancy in terms of credit derivatives products. In order to enrich the tools for credit risk mitigation for market participants, enhance the risk-sharing mechanism and to promote sustainable growth in the financial market, NAFMII put forward a pilot scheme for Credit Risk Mitigation Instruments in October 2010. On 5 November 2010, China's first batch of Credit Risk Mitigation Instruments was formally launched. Nine different traders including China Development Bank, Industrial and Commercial Bank of China, China Construction Bank, Bank of Communications, China Everbright Bank, Industrial Bank, Minsheng Bank, Deutsche Bank and China Bond Insurance Co., Ltd. made the first 20 deals in respect of credit risk mitigation agreements, with nominal value totalling RMB 1.84 billion.

Non-policy debt financing tools

Graph 8: Non-policy debt financing instruments 2007-2010



Source: China Central Depository & Clearing Co., Ltd.

KPMG comment

The corporate bond market is dominated by a small number of issuers, mostly state-owned or formerly state-owned enterprises. As the market develops, we expect privately-owned enterprises to enter this market more strongly.

The three major types of debt financing instruments issued by the domestic financial institutions are financial bonds, subordinated bonds and hybrid capital bonds. In response to increased capital monitoring by the CBRC, more subordinated bonds are being issued by banks to serve as supplementary capital and there has been an expansion in the size of subordinated bonds in issue. This was of particular significance in 2009 under the proactive fiscal policy and easing monetary policy which led to a surge in credit lending. Banks issued about RMB 300 billion in subordinated bonds to supplement capital. The normalisation of credit lending in 2010 and the suggestion to supplement core capital by equity financing from regulators have led to the issuance of subordinated bonds falling back to 2004-2008 levels.

Non-bank financial institutions bonds picked up in 2009 with issuances worth RMB 22.5 billion during the year, comprising eight deals all issued by financial companies. In September 2009 the PBOC and the CBRC jointly issued a notice to introduce finance lease companies and auto finance companies as bond issuers. This is a further step to enlarge the types of non-bank financial institutions that can act as issuers. In 2010 there were four deals issued by finance lease companies with a value of RMB 3.5 billion and one deal issued by an auto finance company with a value of RMB 1.5 billion.¹⁸

Openness and enhancement

While China's bond markets are becoming more open, restrictions still exist in some key areas. In the primary market, issuers of domestic bonds are limited to domestic institutions and the channel for foreign institutions to issue bonds domestically has yet to open. Although certain QFII are able to participate in the secondary market, domestic investors remain the key participants. Domestic investors are starting to invest in overseas bond markets, but the scale is still building.

The internationalisation of the bond markets has accelerated, but here again there is room for further progress. Since 2007, when the Chinese government gave approval for domestic financial institutions to issue RMB bonds in Hong Kong, there have been more than 60 offshore RMB bonds issued in Hong Kong with capital raised amounting to RMB 80 billion.¹⁹

¹⁸ China Central Depository & Clearing Co., Ltd.

¹⁹ DBS Bank Research: The Allure of Dim Sum Bonds, 31 March 2011

The government has adopted policies to promote the issuance of US dollar bonds in the domestic inter-bank bond market to replace the foreign debts — which are costly to service — of relevant large and mid-sized state-owned enterprises.

On 11 May 2009, China National Petroleum Corporation issued a USD 1 billion 3-year term note in the inter-bank bond market to support the financing of its overseas projects. It was the first foreign currency bond issued domestically by a Chinese non-financial institution. The success of the issuance of the USD medium-term note pioneered a new channel for financing in foreign exchange — a well-received financing option for strong domestic enterprises who are now able to obtain foreign capital at lower costs.

In August 2010, PBOC announced the “Notice on Pilot Scheme for Renminbi Clearing Bank and Other Eligible Institutions outside the Mainland to invest in the Mainland’s Inter-bank Bond Market”. The notice clarified three types of qualified institutions outside the mainland authorised to use RMB to invest in the inter-bank bond market and signalled to the market that approval for offshore RMB to enter China’s capital market was gradually gaining traction.

In October 2010, the PBOC, the Ministry of Finance, the National Development and Reform Commission (NDRC) and the CSRC revised the “Provisional Administrative Rules on International Development Institutions’ Issuance of RMB Bonds” notice, allowing issuers to directly remit RMB raised overseas, effective September 2010.

KPMG comment

A number of international institutions are now qualified to trade on the inter-bank bond market. This is another exciting step in the development of the bond market and one which could bring more international investment experience and practices.

Refinement of the regulatory environment and policies to accelerate growth

The regulatory environment for China’s bond markets has steadily improved since 2007. On 9 April 2008, the PBOC circulated the “Measures on the Administration of Non-Financial Corporate Debt-Financing Instruments at the Inter-Bank Bond Market”, under which the PBOC transferred oversight of debt financing matters that were self-regulatory and administrative in nature to NAFMII. These measures emphasised market participation and gradually combined regulatory supervision with self-regulation as the market framework.

Later in 2008, the General Office of the State Council issued the circular “Several Opinions on Providing Financial Support for Economic Development”, which provided more explicit direction on the expansion of bond issuance and development of bond financing instruments as enterprise bonds, corporate bonds, short-term financing bonds and mid-term instruments.

The NDRC has also indicated four areas where it wants to see positive changes. The first is to expand the scale of financing by changing the model by which NDRC would pre-set the annual maximum volume of bond issuance. Second, in order to enhance the efficiency of financing, a two-step mechanism to “examine volume first, then approve issuance” would be streamlined into one approval process, expediting efficiency and shortening the period required for the issuance. A third objective is to diversify the types of guarantee which would promote stability in the corporate bond market. The fourth is to emphasise the improvement of market fundamentals to form an effective mechanism in the market on the identification, sharing and containment of risks.

Areas slated for improvement include raising the awareness of corporations on debt repayments, strengthening information disclosure and allowing intermediaries full functionality of their roles regarding credit rating, underwriting, fixing of interest rates, auditing financial information and legal advice provision.

In May 2009, the “Notice of the State Council on Ratifying and Forwarding the Opinions of the National Development and Reform Commission on Deepening the Reform of Economic System 2009” was announced. Point 10 of the opinion, “deepening the reform of the financial system and establishing a modern financial system”, mentioned the gradual formation of centralised and standardised self-regulatory rules and standards for the bond markets — achievable by improving the market-oriented issuance mechanism for bonds and improving self-regulated and risk-sharing mechanisms.

A future state

The relatively small scale of China’s bond markets means there is a need to strengthen innovation in financial products, trading rules and market fundamentals, in order to broaden and deepen the bond markets.

The future of China’s bond markets will be shaped by market demand and increasing variety in terms of products, types of issuers, duration, interest calculation, guarantees and currency denomination. Providing the right support for innovative products and developing the right mechanisms will be important. One form of innovation could lie in the methods for bond issuance, such as considering private placement for non-financial institution debt financing. Another way is to accelerate the pace of product innovation would be to further expand the asset securitisation business and innovation on offshore RMB debt financing instruments to satisfy the needs of foreign enterprises seeking direct RMB finance. Further ways to promote reform could include introducing new settlement arrangements such as bilateral netting, multilateral netting, and day-time batch settlement to enhance efficiency and minimise risks.

In addition, the composition of the investors can be enriched by cultivating and developing qualified institutional investors. This can be done by encouraging various institutional investors to enter the bond markets to boost diversity and variety on the market demand to achieve active trading in the market. The deployment of related systems and measures can also be accelerated to facilitate offshore institutional investors to enter the inter-bank bond market.

A sound market-oriented self-regulatory mechanism needs to be established by strengthening the credit rating system. This could be done by enhancing methodologies, developing a corporate governance framework that is investor-oriented, increasing cultivation of qualified ratings agencies, and establishing and enhancing the standards and norms for professional conduct. More broadly, information disclosure mechanisms need to be strengthened by establishing a model that is clear and easy to operate, strikes a balance on the disclosure for conflicts of interests, and continually assesses the timeliness, continuity and comprehensiveness of the information disclosed.

Based on the availability of information and controllability of the risks, instruments for credit risk management should be promptly introduced according to actual market demand. This allows investors to diversify and transfer risks using market tools based on their own preference and undertaking and hence improve peoples’ ability to share risks.

Case study

Helping on both sides of the market

Sandra Lu, LLinks Law Offices

As a partner in the asset management practice of Shanghai-based law firm LLinks, Sandra Lu has advised around 40 fund managers and trust companies on the creation of products including equity funds, bond funds, monetary market funds and ETFs. With a client base evenly split between foreign joint ventures and domestic companies, her role includes advising on and drafting contractual arrangements for the establishment of new funds, helping in negotiations in the formation of new JVs, and assistance in obtaining regulatory approvals.

Ms. Lu has also advised a number of international investment banks which are acting as advisors to domestic funds with QDII quotas to invest in international markets. "The international institutions have a useful role to play here, because there are so many funds globally for Chinese funds to choose from. It can be daunting trying to decide which will be the most suitable to invest in," she says.

One unique feature of the China market is that an institution may have to deal with one of three possible regulatory bodies – the CSRC, the CBRC and the CIRC. "The asset management market in China is still highly regulated, so foreign firms need to understand the restrictions, guidelines and legal

risks," she explains. "It is a bit more complicated than in Hong Kong or the US, where you would only have one regulator to deal with the SFC or the SEC."

Ms. Lu shares the example of one international firm which spent a lot of time on regulatory compliance but then realised they had been dealing with the wrong authority. "Without the right advice at the outset, there is a risk that you can go down the wrong path," she notes.

Navigating the regulatory landscape is particularly critical for domestic managers as well, particularly when they apply for QDII. "There are four main types of institution currently applying for QDII, namely fund managers, securities firms, banks and trust companies," she explains. "The regulations, the criteria and the length of time required to obtain the QDII licence will differ quite markedly according to the type of company that is applying."

The last two or three years have seen many developments, Ms. Lu believes. "The local fund managers, securities firms and trust companies are becoming more mature. Portfolio managers have gained lots of experience and have more reasonable

and professional investor philosophy. They are conducting more thorough research and this is enabling them to make more sound decisions based on underlying value. As they build up their own capabilities, we have seen number of local fund managers ending their engagements with international firms."

She expects this trend to continue as many domestic fund companies are now looking to go overseas to recruit talented fund managers. She expects the pool of experienced managers will continue to deepen.

A related point is that with the relaxation of approval processes, a greater number of products are now on the market and Ms. Lu believes this has stimulated competition and also helped the market evolve. "In the past, marketing was very important to attract investors. But now, the products speak for themselves. With more products available, people can see clearly which have superior performance and that means the marketing element has become less important."

Derivatives markets



Derivatives products remain in their infancy in China, but with companies facing the prospect of rising commodity prices and fluctuating exchange rates there is increasing demand from both the real economy and financial sector for products that can help in controlling business risks. Exchange rate reform and greater capacity for interbank settlement are part of the gradual maturation of China's capital markets environment which will create the conditions for growth in derivatives.

Having seen the systemic impact potential of derivatives trading during the GFC, China's regulators have taken a cautious approach to the market. The stability of financial markets and their potential to affect the wider economic environment remain prime concerns.

The market has expanded gradually during the past two years. The market for existing products has grown and global conditions have not deterred regulators from launching several new instruments, notably stock index futures and CDS-like credit products. By the end of 2010, the product categories available in China's derivatives markets covered major financial areas such as interest rates, foreign exchange, equities, commodities and credit. Where new products have been authorised, the market reaction has often been almost instantaneous. For example, in November 2007, China CITIC Bank entered the first RMB Forward Rate Agreement transaction with another financial institution on the same day that the regulations on these products were released.

The conditions for launching the RMB option transactions have matured — the increased RMB/foreign exchange (FX) volatility range, the establishment of a centralised financial clearing system and the development of the RMB money market and bond market have formed a solid base for a more advanced Chinese financial market.

Recent market and regulatory developments

Interest rate and FX derivatives

With 18 market makers including not only the 'big four' state-controlled commercial banks, but also subsidiaries of multinational banks such as HSBC and Citigroup, China's inter-bank FX derivatives market has experienced tremendous growth. This is likely to continue as RMB foreign exchange reforms are enacted. The FX swap and forward market has grown to a market with notional amount of hundreds of billions of US dollars every month, based on statistics provided by the China Foreign

Exchange Trade System. This increase indicates the great need for Chinese banks to hedge their foreign currency positions with the backdrop of RMB appreciation against major currencies.

In the inter-bank RMB interest rate derivative market, interest rate swaps are the most popular instrument. With up to 20 market makers, volumes have increased steadily. The monthly transaction notional amount of interest rate swap hit RMB 300 billion in December 2010. The bond forward transaction has been frequently used by financial institutions as well, and trading volume was kept between tens to hundreds of billions of RMB per month in 2010. An interesting feature of the bond forward market is that the transactions are mostly made by city commercial banks and to a lesser extent joint-shared commercial banks. The RMB forward rate agreement, however, has not received much attention. Recorded transactions of Forward Rate Agreement were limited in 2010, with a total notional amount of RMB 3.1 billion.

At the onset of the GFC in 2008, many state-owned companies incurred significant losses on derivatives transactions with foreign financial institutions. As a response, the CBRC released new guidelines in which it proposed more stringent requirements on the customer-driven derivatives business of financial institutions. The new regulations have cooled the aggressive growth of the Over-The-Counter (OTC) derivative market, taking into account the fact that some banks and their customers are not prepared with adequate risk management for derivative transactions.

Equity derivatives

The introduction of stock index futures, in 2010, has increased the complexity of China's financial markets, since investors were previously not permitted to take short positions. The market is expected to become less volatile as investors can now hedge their exposure without selling the shares when there is a sharp or broad market decline. From April to December 2010, the cumulative volume of futures contracts was over 91 million lots with about RMB 82 trillion of turnover. This accounted for about 27 percent of the overall futures market in China.²⁰

Institutional investors — including mutual funds, brokerages and QFIIs — and individual investors are all allowed to participate. QFIIs can have up to three accounts under authorised mainland futures brokers to trade stock index futures. Only trades for hedging purposes are permitted, which means QFIIs cannot engage in speculative trading. They must not hold index future contracts that exceed their total QFII quota at the end of each trading day. To avoid frequent intra-day trading, the regulator also limits the intraday turnover of the index futures capped by its total QFII quote.

In order to control the inherent high risk of futures trading, the regulator has set up a number of rules. For instance, the required margin, or minimum amount of the contract value that an investor must post is at least 12 percent. The holding of an individual investor is limited to not more than 100 lots to reduce the risk of excessive speculation in the market. In addition, a minimum entrance amount of RMB 500,000 should be applied to individual investors.

The option market is a different story. In 2005, warrants returned to the China market when a programme to sell off large blocks of non-tradable state shares to public investors was launched. The listed companies were permitted to issue warrants in compensation for their plans to list previously non-tradable shares. Warrants had become another channel for listed companies to raise funds and another financial instrument for investors to trade.

The warrant market was popular in 2008 with transactions turnover standing at RMB 5.9 trillion, 22 percent of the total turnover on the SSE.²¹ However, the market cooled dramatically towards the end of the year. By 2010, only one warrant issued by Changhong was still trading on the SSE, down from a peak of more than 20 prior

²⁰ China Futures Association
²¹ Shanghai Stock Exchange

to the GFC. Volatility and disorderly price movements have deterred many investors from this market and the prospects for a revival of this market look slim as other financing channels become available.

Credit derivatives

China's domestic bond market has grown significantly in recent years in terms of the overall market size, but as outlined in the previous chapter, the proportion of debt securities issued by the corporate sector remains low.

The government has realised that one reason for this situation is the lack of hedging instruments for investors to manage issuers with low credit ratings. Although credit derivatives were blamed by some Western countries for inflaming the GFC, China's regulators have been considering launching a domestic credit derivatives system in a prudent and gradual manner and controlling potential risk with more rigorous regulations.

In October 2010, the PBOC approved the guidelines for credit derivatives trading in the inter-bank market. In light of this, recognised market participants began to trade credit derivatives in November 2010. According to PBOC guidelines, two types of credit products were permitted. One is named Credit Risk Mitigation Agreement (CRMA). It is quite similar to the CDS in international markets, but the underlying fabric of a CRMA is simplified to represent a specific issue of an entity, rather than a class of issues of the entity as defined in a typical credit default swap contract. The other type is named Credit Risk Mitigation Warrant (CRMW). Unlike the OTC derivative products, CRMW is a standardised contract and can be traded in the inter-bank market after issuance as a standalone instrument. This significantly increases market liquidity and reduces counterparty credit risk.

KPMG comment

While derivatives remain in their infancy, the market for suitable products, such as stock index futures, can grow spectacularly once successfully launched.

The guidelines set high requirements on the market participants of the credit derivatives trading in terms of minimum capital, valuation and risk management capabilities and experienced personnel. In addition, from the perspective of trading intention, market participants are stratified into three levels; core trading institutions, trading institutions and general participants. Core trading institutions are regarded as market makers, while general participants can only enter into transactions for hedging purposes. By the end of 2010, 23 core trading institutions and 32 trading institutions were appointed, selected from financial institutions including bond insurance companies, commercial banks and securities companies.²² In particular, domestic subsidiaries or branches of foreign institutions such as HSBC, Standard Chartered Bank, JPMorgan Chase and Deutsche Bank were also allowed to be included in the core trader or trader list.

Alerted by the lessons learnt from the GFC, China's regulators have set stricter rules such as leverage caps to avoid overly-speculative activity. For instance, the total issuance value of a CRMW should not exceed five times that of the underlying debt. Further, regulators put more effort into market transparency and regulatory supervision. All market transactions should be reported to the regulatory body.

Commodity derivatives

The trading of commodity futures has a history of about 20 years in China. It is still growing very rapidly. Trading activity is conducted in three locations; the Shanghai Futures Exchange, Dalian Commodity Exchange, and Zhengzhou Commodity Exchange. The categories covered include gold, copper, aluminium, zinc, natural rubber, cotton, sugar, rice, wheat, palm Olein, soybean and PVC. In 2010, China's futures markets recorded a total trading volume of 3.042 billion contracts and turnover of about RMB 227 trillion, up 41.0 percent and 73.9 percent respectively year-on-year.²³ With China concerned by social impacts of unstable food prices, as well as the potential for commodities to influence export competitiveness, we may see companies being encouraged to look more closely at strategies involving commodity derivatives.

²² Data Source: National Association of Financial market Institutional Investors.f

²³ Data Source: China Futures Association

Case study

Meeting the challenges of a sophisticated capital market

Peter Zhang, Deputy Director General, China Banking Regulatory Commission

As China's capital markets evolve, Peter Zhang of the CBRC sees many challenges in restraining unlawful practices such as market manipulation, while boosting investors' abilities to manage risks. "The turnover rate of China's stock market has been higher than almost any other stock markets in the world, with one notable exception being the NASDAQ," Mr. Zhang comments. "To me, this indicates that the market is still overly speculative and that the proportion of medium- to long-term investments is relatively low. This will affect the resource allocation on the stock market and its contribution to the real economy. The relative lack of products such as stock index options, have hindered the effective management of market risks."

Mr. Zhang believes financial markets can play more of a role in helping people build wealth, and in stimulating consumer spending, a major government target under the government's 12th Five-Year Plan. "If the securitisation ratio of China increases steadily from 67 percent at the end of 2010 to a target of about 100 percent by 2020, the stock market capitalisation of China will by then stand at around RMB 120 trillion (USD 18.34 trillion), which is equal to four or five times the A-share market capitalisation of China by the end of 2010," he

explains. "The increase in stock market capitalisation will provide great impetus for consumer spending and economic restructuring, and its contribution to the world economy will be unlike anything in history."

From his perspective with the CBRC, but with many years of investment banking experience not only in China but also in New York, Mr. Zhang sees many areas where banks will need to respond and innovate, particularly as the internationalisation of the RMB moves ahead.

The internationalisation process of the RMB is the liberalisation process of the capital account, and this could lead to a two-way acceleration of capital flows. "The internationalisation of RMB will give impetus to the 'marketisation' process of the interest rate, and in turn this will create an exceptional opportunity for Chinese banks to change their business model. The rapid development of both the stock and bond markets could generate a huge demand for over-the-counter or pit trading products such as stock index options, stock options, interest rate swaps, forward rate agreements, interest rate futures and interest rate options. The increase in two-way cross-border investments will create a higher demand for the development of the

RMB FX market, especially the foreign exchange forwards, futures, swaps and options markets."

Mr. Zhang feels that the internationalisation of the RMB needs to proceed at a pace which matches China's growing role in the world economy. He predicts that by 2020, a multi-level capital market will have been established, and various financial institutions, enterprises and individuals will be more directly exposed to international risks of all kinds. "One of our major tasks in the future is to boost financial institutions' competitiveness on condition that all risks are effectively managed. One of the key ways to boost competitiveness is to enhance these institutions' innovation ability by studying existing products overseas and launching similar markets, and by striving to improve our own regulation and supervision skills," he concludes.

Peter Zhang is author of numerous books on derivatives and product innovation in China's capital markets. His most recent book, *The Chinese Yuan: Internationalization and Financial Products in China*, was published in 2011 by Wiley Finance.

Outlook for the next decade



China's State Council has declared its intention to develop Shanghai into an international financial centre for 2020 to compete directly with locations such as London and New York. This plan is compatible with forecasts for the size of China's economy and supports the objective of internationalising the RMB.

Shanghai is already a global city and home to one of the world's largest stock exchanges, with an economy that surpassed Hong Kong's in size last year.²⁴ As this report details, the level of securitisation within China's corporate sector is still low compared to other mature markets and there is potential for sustained growth of fixed income and derivative products, areas which remain very much in their infancy, over the next decade.

Recent moves by the big four Chinese state-controlled banks to build up their offices in Shanghai is another sign that the city is taking a step closer towards becoming an integrated financial centre for the domestic and international markets.

However, Shanghai's prospects over the remainder of the decade will clearly be shaped by several factors:

The roll out of the International Board: One part of the government's plan to develop the Shanghai Stock Exchange involves the creation of an International Board allowing foreign organisations to access the Chinese market, and domestic investors to share in the returns achieved by international companies. A debut could conceivably occur before the end of 2011, but a precursor to that will be clearer guidance around financial reporting, supervision and disclosure requirements. Once listing rules are in place, there may be a need for further clarification around currency convertibility or repatriation.

Currency liberalisation: Over the last few years, the government has introduced a series of measures to liberalise the RMB. A number of motivating factors are underpinning this reform, most notably China's desire to open up its capital account and promote the RMB as an international currency. This will support China's long-stated ambitions to transform Shanghai into an international financial centre, and make the RMB an international reserve currency by 2020. This intention was most recently articulated in a PBOC report published in March 2011. The authorities do remain concerned by the possibility of economic and systemic risks, so while there

²⁴ "Shanghai's GDP in 2009 surpasses Hong Kong," China Daily, 8 March 2011

is the potential for some key progress in removing convertibility restrictions, the government will continue to hold an interest in overall currency stability. China's economic fortunes over the medium term will be critical in shaping the pace at which currency liberalisation occurs.

Talent: Deeper capabilities in research and accumulated experience in portfolio management and risk management will be critical foundations for the development of capital markets. Many domestic companies have matured and in some cases this has been strengthened through hiring of international expertise. While investment in training and developing management expertise will be critical, this will also be supported by the creation of a more complete and well managed ecosystem featuring other mature market participants such as ratings agencies and law firms.

Tax competitiveness: When it comes to attracting talent to the financial sector, mainland China's tax rate (currently up to 45 percent for individuals) puts it at a disadvantage to Hong Kong, where taxes are lower (17 percent for companies and 15 percent for individuals). While the potential tax burden for financial organisations operating in Shanghai may be comparable to London and New York, the government may have to do more to ensure competitiveness at the regional level.

Although these factors will present challenges, there is reason to remain cautiously optimistic about China's prospects and the future role that Shanghai will play. Shanghai is still some way behind other international financial centres in terms of market openness, size and variety, as well as sophistication of sophistication of products. To become such a centre, the authorities recognise that they will have to open up these markets further. This could include full currency convertibility and opening up of RMB-denominated A-Shares to foreign investors.

What is evident is that China is firmly set on this ambition. By setting 2020 as a target, the State Council is already considering incentives for departments to lift restrictions, simplify regulatory processes and push towards this goal. It is a journey that China has already embarked upon and all businesses need to start thinking about the impact this will have on their business - whether they are a domestic or international business.

Appendix: Registration and tax guidelines for QFII

To participate in China's onshore securities market, a QFII needs to obtain approval from the CSRC for a licence and from SAFE for a quota. Under the rules established by the CSRC and revised in 2006, to be eligible to apply for QFII status, fund managers and insurance companies must have been in operation for at least 5 years and have at least USD 5 billion in assets; securities firms must have an operating history of at least 30 years and minimum assets of USD 10 billion; and commercial banks must be ranked among the top 100 worldwide in terms of assets and have securities assets of at least USD 10 billion.

The new set of QFII Provisions on Foreign Exchange Administration for Onshore Securities Investment promulgated by SAFE in 2009 superseded its predecessor promulgated back in 2002, and addressed various issues in relation to QFII investment including quotas, account management, conversion and remittance, disclosure and reporting.

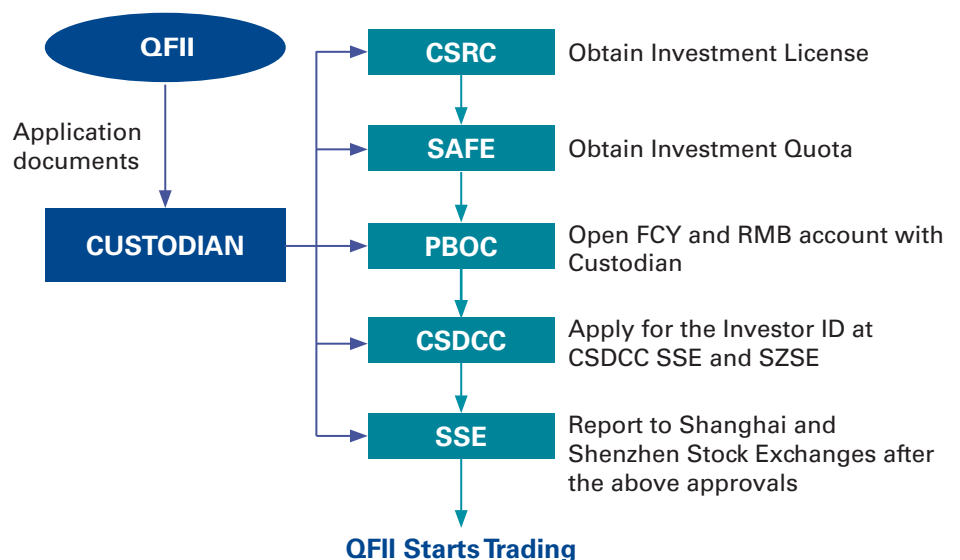
In detail, upon approval of both status and quota, the QFII institution needs to appoint a domestic commercial bank to act as custodian of its assets, and name a domestic securities company to handle its trading activities. The QFII then opens a special RMB account for clients with the custodian bank and can only remit foreign capital to that account. A QFII should also open one account for its own funds (proprietary account) and one for each of its Chinese funds, but transfer of funds between client accounts, proprietary accounts and open-ended Chinese fund accounts is strictly prohibited.

QFIIs are also restricted from transferring or selling investment quota. A QFII can invest in A Shares, treasuries, convertible debt and other financial instruments, including IPO issues. The percentage of shares held by a single QFII in any listed company cannot exceed 10 percent of the company's total outstanding shares and the aggregate percentage of shares held by all QFIIs in any listed company must not exceed 20 percent. The capital lock-up period of 1 year for QFIIs remains in force although there is an exception of 3 months for medium- and long-term QFII funds.

Tax rules

With effect from 1 January 2009, QFIIs are required to pay 10 percent tax on their income earned in China (including dividends and interest). For dividends, taxes due shall be withheld by the payer of such income, and for interest, the tax shall be withheld by the payer at the time of payment or when it becomes due. Every local tax bureau is required to monitor closely all projects that have QFII investments, provide QFIIs with adequate tax service, set up files for easier tax management and ensure QFIIs are fully taxed with reference to the withholding tax regulations.

Application process



Glossary of terms

CDS	Credit Default Swap
CIC	China Investment Corporation
CIRC	China Insurance Regulatory Commission
CRMA	China Regional Monitoring Agency
CRMW	Credit Risk Mitigation Warrant
CSRC	China Securities Regulatory Commission
ETF	Exchange Traded Fund
FX	Foreign exchange
GAAP	Generally Accepted Accounting Principles
GFC	Global Financial Crisis
HKEx	Hong Kong Exchanges and Clearing Limited (Hong Kong Stock Exchange)
IFRS	International Financial Reporting Standards
OTC	Over-The-Counter
NSSF	National Social Security Fund
PBOC	People's Bank of China
QDII	Qualified Domestic Institutional Investor
QFII	Qualified Foreign Institutional Investor
RMB	Renminbi
SAFE	State Administration of Foreign Exchange
SSE	Shanghai Stock Exchange
SZSE	Shenzhen Stock Exchange
SWF	Sovereign Wealth Fund

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