2018 SERIES: GREATER GATEWAY TO CHINA

Stock Connect: Charting a future course

ASSET SERVICING

BNY MELLON

> 2018 will be Stock Connect's 'road to Damascus' moment- MSCI inclusion will provide the much needed fillip as interest in the scheme will continue to grow and develop into the future

Mathew Kathayanat
APAC Head of Product and Strategy
Asset Servicing, BNY Mellon

Introduction/Executive Summary

Just over three years old, the Stock Connect scheme linking the markets of Hong Kong and China has already emerged as one of the core pillars of international investors' strategies to access Chinese equities. And with increasing global interest and participation in China's markets, Stock Connect's importance looks set to grow.

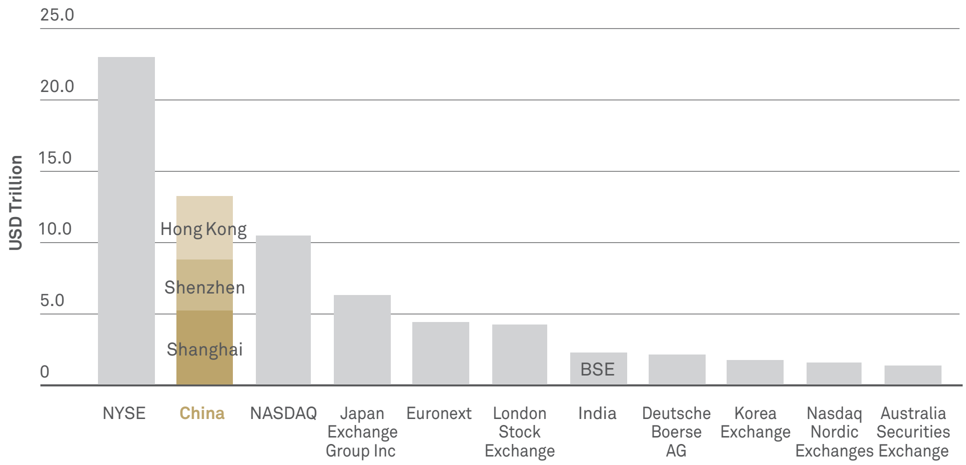
At the same time, the pace of change observed in China as well as the broader global investment landscape mean Stock Connect will, to some extent, always be evolving. The question is how the evolution will benefit investors and China's equity markets as a whole. This paper, based on the views of subject matter experts from BNY Mellon and regulators and in-depth research, will explore the current realities and future potential of Stock Connect, and examine how it has developed thus far, and course it will chart in the near-term. The paper also looks at the potential advantages and drawbacks versus other market access schemes, the challenges Stock Connect scheme faces and how these are being addressed, as well as its possible extension to other asset classes and connection with other jurisdictions.

A Trip Back on the 'Through Train'

To understand where Stock Connect is going, it's important to look at where it has begun. After an initial announcement on mutual market access in April 2014 by Chinese Premier, Li Keqiang, Hong Kong and China established trading links between the Shanghai-Hong Kong exchanges (Shanghai-Hong Kong Connect) in November 2014 and subsequently the Shenzhen-Hong Kong exchanges (Shenzhen-Hong Kong Connect) in December 2016 just within a short span of two years.

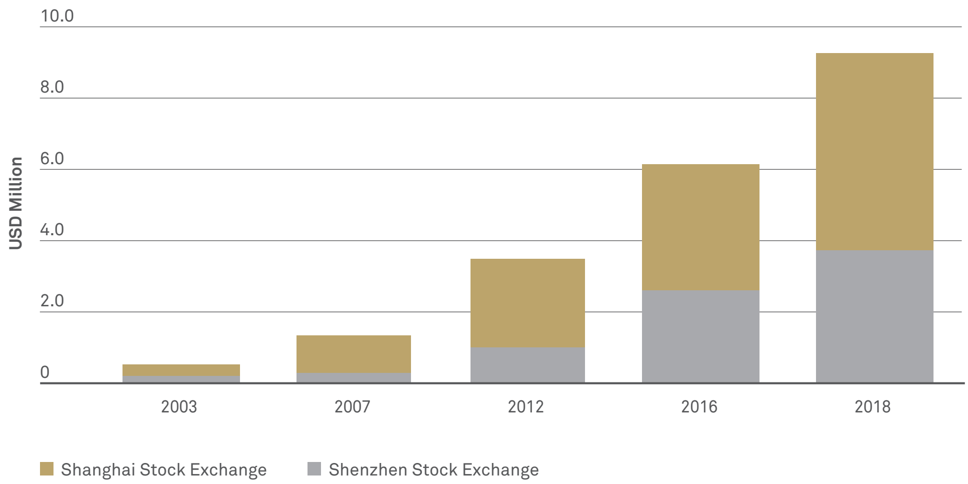
Stock Connect allows foreign investors to invest in China A-Shares through brokers in Hong Kong (northbound trading) and mainland Chinese investors to invest in Hong Kong stocks through brokers in China (southbound trading). It provides foreign investors with unprecedented access to China, now the world's second largest equity market in terms of capitalization (Figure 1) with a compound annual growth rate (CAGR) of 20% between 2003 and February 2018 (Figure 2).

Figure 1. China: The 2nd largest equity market in the world



Source: World Federation of Exchanges, February 2018

Figure 2. The Growth of China Equity Markets (2003 - February 2018)



Source: World Federation of Exchange, February 2018

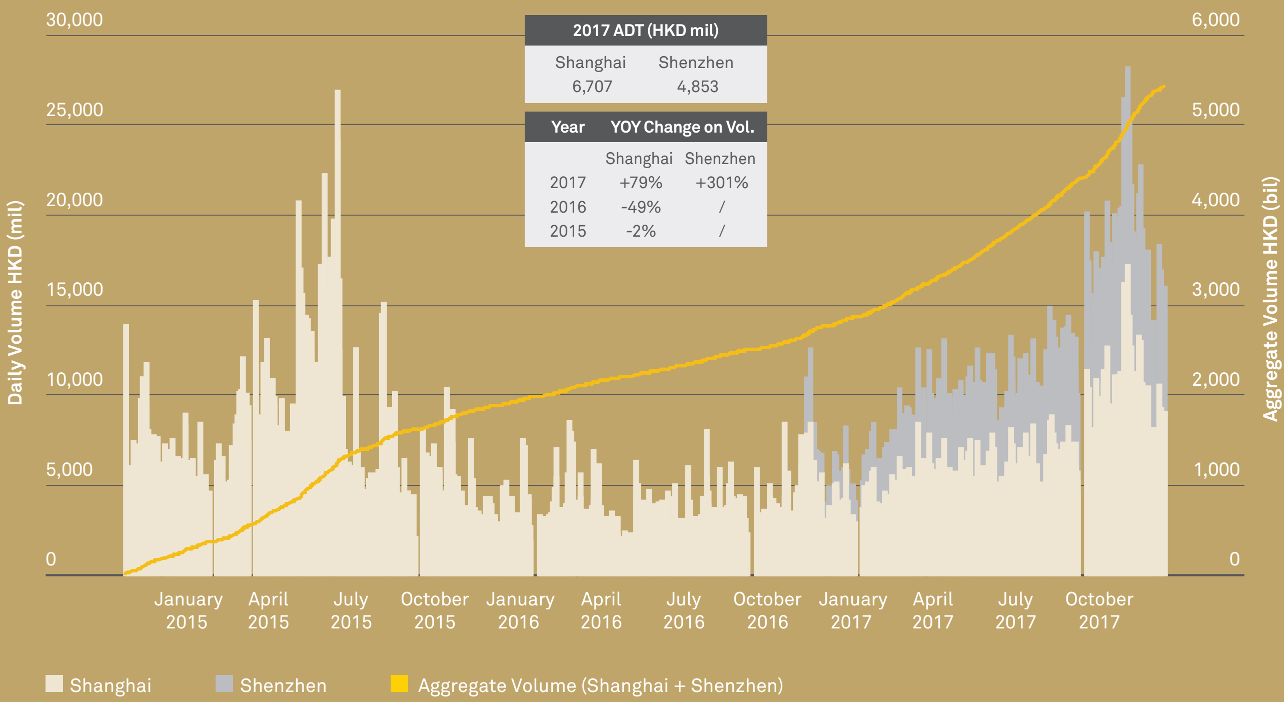
Not surprisingly, foreign investors have been quick to seize on the opportunity. Northbound trading volumes and cleared portfolio values have surged since the scheme's inception (Figures 3 and 4). From a slow initial start [1], Stock Connect has in many ways exceeded expectations, and is set to gather further momentum as Chinese shares are steadily added to international indices.

The upcoming inclusion of over 200 large-cap Chinese stocks in the MSCI Emerging Markets index "will provide opportunities for global investors to diversify their asset allocation into China A-Shares market." says Tae Yoo, Managing Director, Global Client Development, Client and Marketing Services, Market Development Division at Hong Kong Exchanges and Clearing Limited (HKEx). MSCI forecasts that the China A-Shares inclusion could draw USD 17 billion of foreign capital to shift and track the China A-Shares market [2].

[1] http://www.asiaasset.com/news/Teething_problems_behind_Stock_Connects_slow_start0412.aspx

[2] https://www.reuters.com/article/us-msci-indexes/china-shares-get-msci-nod-in-landmark-moment-for-beijing-idUSKBN19B325

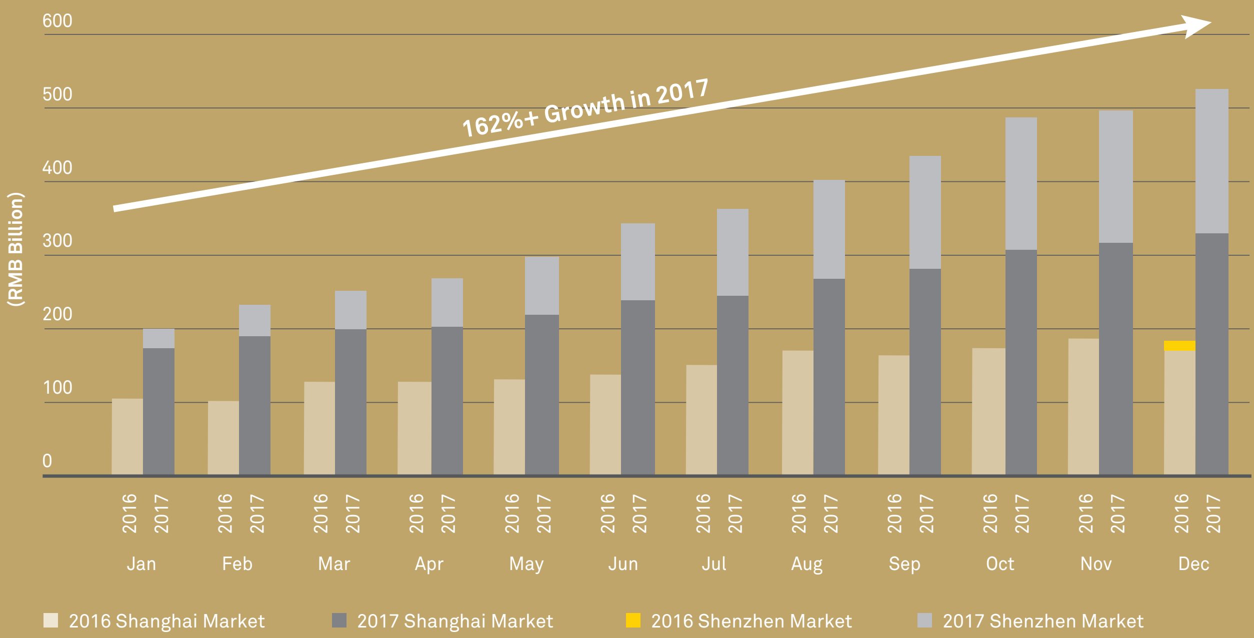
Figure 3. Stock Connect Northbound (Shanghai and Shenzhen) Aggregate Volume



Source: HKEX, December 2017

Figure 4. Northbound Stock Connect Cleared Settlement Portfolio Value

Reached RMB 530 billion (USD 77 billion) in Northbound portfolio value.



*Source: HKEX, as at month end from January 2016 to December 2017

QFII and RQFII: Complementary or Competition?

As Stock Connect gains strength, it will inevitably impact the other international routes to China's markets –the Qualified Foreign Institutional Investor (QFII) and Renminbi Qualified Foreign Institutional Investor (RQFII) schemes. These schemes are quota-based and require licensing and regulatory approvals, but have their superiority in terms of access and restrictions.

Under Stock Connect, investors can trade over 2,000 eligible stocks, but these only represent around half of the shares listed on the Shanghai and Shenzhen exchanges. QFII and RQFII provide access to a wider pool of shares as well as other onshore financial instruments, such as bonds. Trading accessibility is also not curtailed for these schemes, while Stock Connect Northbound trading is only possible on days when both the Hong Kong and Mainland Chinese exchanges are open.

On the other hand, compared to QFII and RQFII, Stock Connect has fewer eligibility requirements and repatriation restrictions. Stock Connect investors are not subject to minimum capital requirements or lock-up periods. And while there is a collective daily trading limit of RMB 52 billion (approximately USD 8.27 billion) applied to foreign investors, this only applies to purchases and has no impact on sale orders.

The discrepancies among the schemes mean all will remain relevant, and that many investors will use a combination to explore the broadest possible range of market opportunities. "The existing schemes complement each other," says Magdalene Tay, APAC Custody Product Manager, BNY Mellon Asset Servicing. "Investors tend to use the onshore schemes for securities that are not available through Stock Connect. But to get quicker access to the market, Stock Connect may be a viable option."

To put Stock Connect's growth in perspective, Mr. Kathayanat notes that around USD 100 billion in quotas have been approved under the QFII and RQFII schemes, whereas Stock Connect has already amassed a portfolio value of some USD 77 billion (Figure 4). "There are strict repatriation rules around (QFII and RQFII) and it would take time for anyone to completely pull out," he says. "Our sense is that all of these access schemes will coexist, but that Stock Connect may well emerge as the largest in time to come."

China Access Schemes
At a Glance

2013

Renminbi Qualified Foreign Institutional Investors (RQFII)

Allows global institutional investors who meet certain qualifications to invest in equities and bonds in China domestic market within an approved quota from 18 eligible jurisdictions via RMB raised outside of China

2016

China Interbank Bond Market (CIBM) Direct Route

Allows global institutional investors access to the China interbank bond market in the domestic market.

2002

Qualified Foreign Institutional Investors (QFII)

Allows global institutional investors who meet certain qualifications to invest in equities and fixed income in China domestic market within an approved quota via RMB raised onshore.

NOVEMBER 2014

Stock Connect (Northbound)

Allows global institutional investors access to Chinese stocks listed on the Shanghai and Shenzhen stock exchanges via Hong Kong.

JULY 2017

Bond Connect (Northbound)

Allows global institutional investors to trade and settle bonds issued in China Interbank Bond Market via Hong Kong.

Figure 5. China Access Schemes for Foreign Institutional Investors

	ONSHORE		OFFSHORE
Access Schemes	QFII	RQFII	Stock Connect (Northbound)
Regulators	China Securities Regulatory Commission (CSRC) State Administration of Foreign Exchange (SAFE)		Securities and Future Commission (SFC) CSRC
Pre-Investment Approvals	CSRC & SAFE (2 to 5 months)		- Not required - Account opening required at Hong Kong Securities Clearing Corporation (HKSCC) (1 day)
Instrument Types	- Securities (equities and bonds) listed on the stock exchanges - Bonds traded on the CIBM - Other financial instruments approved by the CSRC		Selected A-listed and H-listed stocks
FX Restriction	CNY	CNH	CNH
Withholding Tax	- Dividend and interest withholding tax:10% - Capital gains tax temporarily exempted		- Dividend and interest withholding tax:10% - Capital gains tax temporarily exempted
Lock-Up Period	- Three months - Starts from date of remittance up to a total of USD 20 million	- No lock-up period for open ended funds Three months lock-up for closed ended funds and up to a total of RMB 100 million	No restriction
Repatriation	- Daily Repatriation after lock-up period expires Monthly repatriation cannot exceed 20% of total QFII investments as of end of last year - Profit repatriation subject to audit reports issued by local accounting firm and tax clearance certificates	Daily repatriation after the lock-up period expires	No restriction
Investment Quota	Filed and approved by SAFE	No restriction	Daily trading limit of RMB 52 billion (USD 8.27 billion) on net buy basis

Note: RMB = The ISO code for renminbi (which may also be used for the yuan) is CNY (an abbreviation for "Chinese yuan"), and also used for CNH which is CNY traded in offshore markets such as Hong Kong

Unlocking the Connect Challenges

For all Stock Connect's successes, there is no denying it continues to present challenges. The scheme is subject to the rules governing China's securities markets, which can differ substantially from international norms. Domestic regulations relating to trading and settlement specify:

- Pre-delivery of securities to the selling broker one day before trade execution to avoid overselling, as fail trades are not allowed in the A-Share market.
- Settlement of securities on Trade Date (T) and cash on T+1.
- Safekeeping of securities in China Clear (an omnibus structure under Hong Kong Securities Clearing Company (HKSCC) Nominees Ltd).
- Turnaround trading and uncovered short selling are prohibited.

The short settlement cycle may be an issue for global investors as the standard is typically T+2 to issue settlement instructions and arrange funding. The timing difference between securities and cash settlement also presents counterparty risk.

Regulators are constantly introducing enhancements to address issues with the scheme and improve operational efficiencies. Earlier on, HKEx began offering special segregated account (SPSA) services to remove some of the hurdles presented by pre-delivery requirements. In 2017, real-time delivery versus payment (DVP) was introduced to address concerns, particularly among regulated funds, about the absence of real-time settlement (Figure 6). "There are still some challenges and constraints, but regulators are trying to make it more viable for investors to participate," says Ms. Tay.

Figure 6. Evolution of Stock Connect Scheme

Apr 2015	May 2015	Apr 2016	Aug 2016	Dec 2016	Nov 2017	Q3 2018 (Tentative)
Special Segregated Accounts Introduced	**CSRC Beneficial Ownership Clarified**	**Delivery-versus-Payment (DVP) settlement introduced ***	**Aggregate Quota Abolished**	**Shenzhen Connect Commences**	**Real-Time DVP (RDP) Enhancement*****	**Investor ID Model ******
Multi-broker execution solution Pre-trade checking solution	CSRC FAQ HKSCC rules amended	Same day settlement finality on T+0 basis 100% growth of SPSA accounts since launch	Aggregate quota abolished Update on beneficial ownership (Oct 27)** HKEX and HKSCC rule amendments (Oct 24) Tax clarification announcement	Build on solid foundation of Shanghai-Hong Kong Stock Connect At launch, 100 small cap stocks listed in HK available	Real-time settlement finality on T+0 basis in RMB, HKD and USD New 4.45pm Batch Settlement Run	Broker-to-Client Assigned Numbers (BCANs) and Client Identification Data (CID) assigned to clients of local brokers in Stock Connect Northbound trading Enable more efficient HK-China cross-border market surveillance

* Source: 26 Jan 2016 HKEX Circular http://www.hkex.com.hk/eng/market/partcir/hkscc/2016/Documents/CE_020_2016.pdf
** Source: CSRC Updated 27 October 2016, http://www.csrc.gov.cn/pub/csrc_en/laws/overRule/PolicyInterpretation/201610/t20161027_305087.html
*** Source: 7 July 2017 HKEX Circular https://www.hkex.com.hk/eng/market/partcir/hkscc/2017/Documents/ce_015_2017.pdf
**** Source: 30 Nov 2017 HKEX Circular http://www.hkex.com.hk/-/media/HKEX-Market/Services/Circulars-and-Notices/Participant-and-Members-Circulars/SEHK/2017/CT09717E.pdf

Mr. Kathayanat agrees Stock Connect is constantly progressing in part because of the spirit of cooperation among all parties involved. “Typically with initiatives like these, the regulators in China and Hong Kong set a broad framework, and the market participants work collectively to resolve the challenges to the benefit of foreign investors.”

One example of this cooperation in action is a proprietary solution designed by BNY Mellon to enhance Stock Connect’s viability to investors in other jurisdictions. The SPSA Plus model, developed by units across the bank including Asset Servicing and broker Pershing LLC, provides a seamless, end-to-end process from trade execution to custody, with real-time settlements that does not require client instruction. Importantly, it can be accessed via any non-Asian location, meaning clients in other financial centers like London and New York can effectively tap into Stock Connect in their own time zones.

“It’s an innovative model that’s scalable, and basically ‘plug and play,’ allowing investors flexibility to use the Connect scheme to access the China markets even when they have no presence in Asia Pacific,” Ms. Tay notes.

Looking forward, one concern is how Stock Connect may cope with a possible surge in demand arising from China’s MSCI index inclusion, which could challenge the daily trading cap and CNH liquidity conditions. However, past experience indicates that when issues like these arise, regulators and market participants have been willing to work together to address them.

A Broader Connect Universe

Stock Connect has already proved to be a vital component in the evolution of China's capital markets as well as playing an important role in the internalization of the renminbi. But the regulators are by no means resting on their laurels.

"Many of the elements of Connect will be scalable and continuously improved for international investors," says HKEx's Mr. Yoo. "Going forward, we will continue to try our best to engage with market participants and regulators to enhance the program. The daily quota and eligible securities will continue to be monitored for potential regulatory review and expansion considerations. The program could also be expanded to other products and asset classes."

After the introduction of Bond Connect in July 2017, the next likely extension is ETF Connect, which would allow Mainland investors to trade funds listed in Hong Kong and Hong Kong investors to trade those listed in Shanghai and Shenzhen. ETF Connect is expected to make its debut later this year and could eventually help to double the value of the regional Exchange Traded Fund (ETF) market.[3]

Stock Connect's success has also spawned discussions on similar links with other major financial centres. The near-term prospects look brightest for a long-planned link between the London and Shanghai exchanges, which People's Bank of China Governor Yi Gang recently said that the government was aiming to launch in 2018.[4] However, market insiders have noted several complexities standing in the way of this goal, including the time zone difference, market maker arrangements and varying transaction mechanisms. These issues, and the fact that solutions like those provided by BNY Mellon already allow investors to trade via Stock Connect in their own time zones, mean other schemes are unlikely to usurp the Hong Kong Connect as the preferred gateway to Chinese assets in the near term.

In essence, as BNY Mellon's Mr. Kathayanat notes, investors have only recently begun to grow comfortable with Stock Connect's infrastructure and risk frameworks, and we are already seeing impressive track record with such level of comfort. The ongoing improvements introduced by the regulators and market participants to address the issues with the scheme that remain, bode well for Stock Connect's future. With international investors currently holding only around 2 percent of Chinese stocks,[5] the Stock Connect scheme, China's markets and investment service providers alike have ample room to develop, and provide new routes to opportunity, for years to come.

[3] https://www.bloomberg.com/news/articles/2018-04-11/china-aims-for-shanghai-london-trading-link-this-year-pboc-s-yi

[4] https://www.bloomberg.com/news/articles/2018-01-24/foreign-investors-boosted-china-stock-holdings-by-81-in-2017

[5] https://www.bloomberg.com/news/articles/2018-01-24/foreign-investors-boosted-china-stock-holdings-by-81-in-2017

We are BNY Mellon

BNY Mellon is a global investments company dedicated to helping its clients manage and service their financial assets throughout the investment lifecycle. Whether providing financial services for institutions, corporations or individual investors, BNY Mellon delivers informed investment management and investment services in 35 countries. As of 31 March 2018, BNY Mellon had USD 33.5 trillion in assets under custody and/or administration, and USD 1.9 trillion in assets under management. BNY Mellon can act as a single point of contact for clients looking to create, trade, hold, manage, service, distribute or restructure investments. BNY Mellon is the corporate brand of The Bank of New York Mellon Corporation (NYSE: BK). Additional information is available on www.bnymellon.com. Follow us on Twitter @BNYMellon or visit our newsroom at www.bnymellon.com/newsroom for the latest company news.

BNY MELLON