The Great China Convergence

Expert Insights from Asset Servicing Live Webcast Series | By Magdalene Tay

Over the past year, we have witnessed further liberalization of China's capital markets. Across the five China access schemes – namely Renminbi ("RMB") Qualified Foreign Institutional Investor ("RQFII"), Qualified Foreign Institutional Investor ("QFII"), Stock Connect, Bond Connect and the China Interbank Bond Market ("CIBM") Direct Route schemes - we are seeing significant steps taken towards the harmonization of the gateways to the country's domestic markets.

BNY Mellon Asset Servicing hosted a live audio webcast titled "The Great China Convergence" in October. Eugenie Shen from Asia Securities Industry & Financial Markets Association (ASIFMA) and Tae Yoo from Hong Kong Exchange and Clearing Limited (HKEX) shared their insights on the various China access schemes, the challenges and milestones, as well as how the future landscape is shaping up. Magdalene Tay from BNY Mellon, moderated the discussion.

Key Challenges and Potential Solutions

At present, global investors accessing China through these schemes are faced with regulatory, market structure and overall enhancement challenges associated with increased investor demand for access, complying with on-shore China market regulation and structural differences to international market practice in operation and regulatory guidelines.

1st The first challenge arises from the discrepancy between the regulatory regime in mainland China and international practices for short selling, block trading, and holiday trading arrangements. For example, true DvP is not available for onshore QFII and RQFII schemes. In addition, market participants and global investors would like block trading to be made available under Stock Connect where currently the transfer of China securities must be conducted on the stock exchange. Holiday trading restriction also limits trading opportunities as global investors are not allowed to trade via Stock Connect one day before a public holiday in Hong Kong or mainland China.

2nd The second challenge is around market structure. The same-day (T+0) trade settlement for China A-shares presents an operational burden for global investors, global custodians and market participants to complete the settlement obligations. In comparison, CIBM (China Interbank Bond Market) Direct/Bond Connect, has the flexibility of a T+1 and T+2 settlement, and hence trade confirmation is not an issue. Implementing changes to a T+0 settlement cycle for Stock Connect is however not an easy task.

Offshore CNH and onshore CNY funding are options available for investment in China bonds. However, there is a limited number of RMB FX settlement banks to support onshore CNY for Bond Connect transactions and most global custodians are not currently able to provide CNY funding. Moreover, global investors can only engage one RMB FX settlement bank for both capital inflows and outflows which raises best execution issues.

3rd Lastly, the complexities behind the market adaptation of future schemes continue to pose challenges. With FTSE and Bloomberg announcing inclusion of China A-shares and bonds into their index franchise, foreign investment in China's capital markets is expected to grow. This means that Chinese regulators will need to work closely with industry players to address funding issues and ensure that the settlement system is robust and performing at a zero-error level to continuously gain investors' confidence.

Key Developments

Technology as an enabler

With the advancement in technology, post trade services can be enhanced to provide efficiency and resiliency. Market participants and regulators are developing innovative solutions to address challenges including different time zones, short settlement cycle and post-trade processing.

In October this year, HKEX confirmed its partnership with Digital Asset to develop a blockchain platform. This digital initiative aims to allow global asset managers to complete post-trade allocations and processing for Stock Connect almost instantaneously. All market participants and counterparties will have real time visibility of the post trade status, allowing for immediate actions to be undertaken. This can mitigate risk of buy-ins while complying with the no-fail T+0 trade settlement requirement for China A-shares, which only allows four hours of operation on post-trade confirmation and allocation after market close.

Uptake on Stock Connect Scheme

There are indications that the industry is welcoming and adapting Stock Connect. We see significant uptake for real-time Delivery versus Payment (RDvP), which facilitates securities and cash to be exchanged simultaneously and on a real time basis. From January to April this year, few investors used RDvP. The surge in RDvP usage began when passive funds started to invest when China A-Shares were first included in the MSCI index in May (Figure 1). In addition, there was also an increase in the number of Special Segregated Accounts (SPSA) opened (Figure 2). The number of SPSA accounts have grown by 157% since January 2018. As of 5 October 2018, there were 6,512 accounts set up.

Figure 1: MSCI China A-Shares Inclusion - Key Observations on RDvP usage

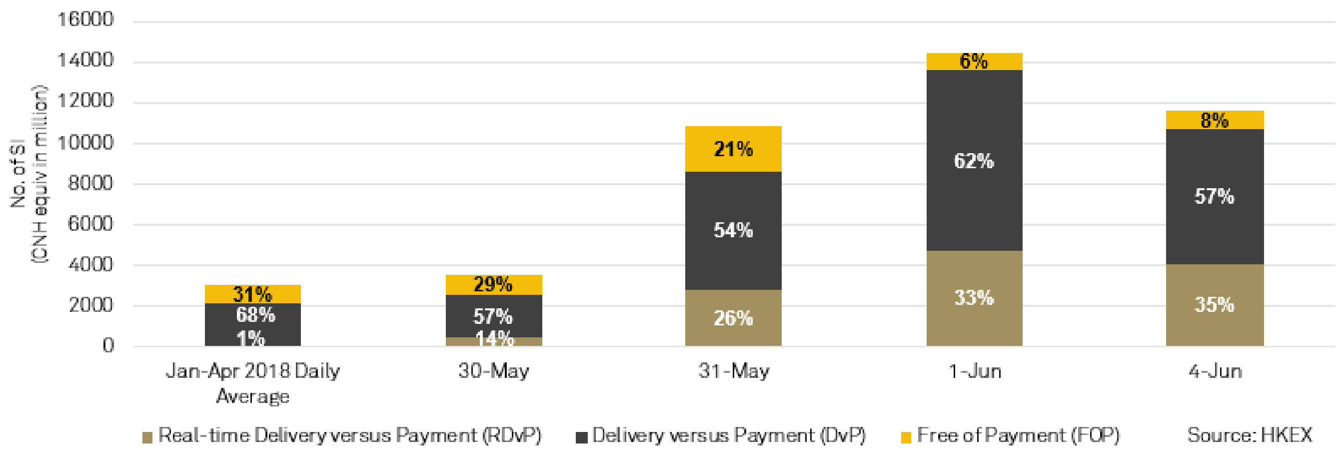
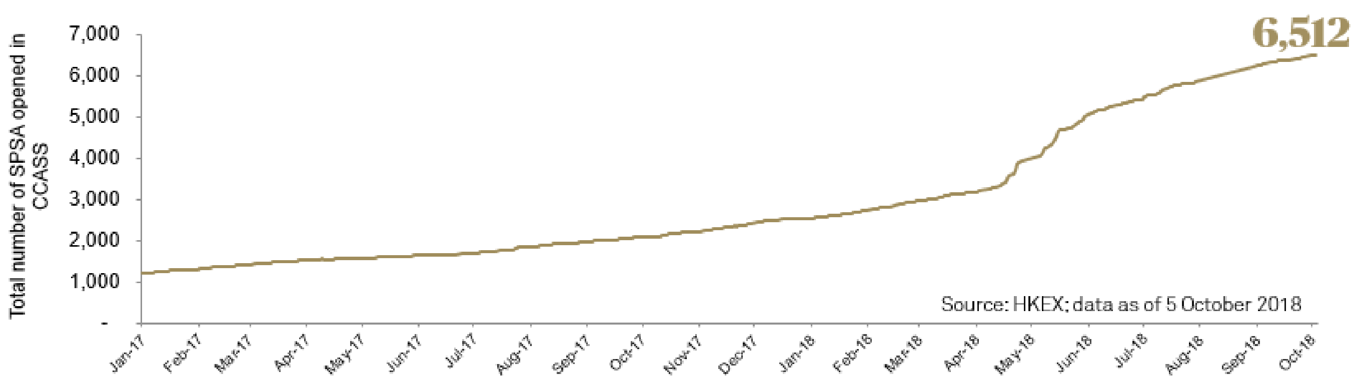


Figure 2: Special Segregated Accounts (SPSA) Highlights



Choice of Schemes for Foreign Investors

There are investors who prefer CIBM Direct route, QFII or RQFII access schemes because of their investment strategies. For some foreign investors, they are looking for ease of access and a cost-efficient way to invest in the China domestic market.

With Bloomberg adding Chinese RMB-denominated government and policy bank securities to the Bloomberg Barclays Global Aggregate Index in April 2019, there will likely be more interest around Bond Connect.

Working Towards Greater Inclusion

Ultimately, for the Great China Convergence to take place, there are considerations that mainland regulators and market participants need to work together to meet foreign investors' needs. While the merger of the five schemes is not something that can be addressed in the immediate future, we do expect the schemes to evolve in the upcoming years as China continues to open up its capital markets to foreign investors.

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