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Financial Services Special Report: China – Hong Kong Capital Markets Connections

SUMMARY

As China reforms and liberalises its financial system, Hong Kong has proved a useful testing ground for Chinese markets connecting to global markets. Stock Connect and Mutual Recognition of Funds are the set piece initiatives, with numerous other pilots in the Free Trade Zones. Uptake by international investors has been gradual, with inward investors concerned about the strength of the RMB and regulatory barriers to participation and repatriation of funds. Despite concerns over tightening capital account and slow down in RMB internationalisation, prospects for continued trading growth and for future initiatives including a Hong Kong-China bond connect.

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China-Hong Kong capital market connections

1. As the largest offshore RMB hub in the world, Hong Kong has proved a useful testing ground for the authorities to pilot new initiatives to open up China's capital account and meet enormous demand for inward and outward investment. This report looks at three initiatives designed to facilitate cross-border investment and capital flows between the mainland and Hong Kong: the Shanghai-Hong Kong and Shenzhen-Hong Kong stock connect schemes; the Mutual Recognition of Funds (MRF) scheme, and tied to all three, China's free trade zones.

Shanghai-Hong Kong Stock Connect

2. The Shanghai-Hong Kong Stock Connect (SSC), launched in November 2014, was China's first attempt to directly link its stock markets to international markets. The pre-existing QFII and RQFII programmes (inbound investment quota schemes) allowed sophisticated blue-chip institutional investors access to Chinese stocks but had been constrained by restrictive rules on asset class, transaction timing and the amount of repatriation. The SSC addressed these issues and also smaller institutional and retail investors access to China's equity market.

3. **Flows have been predominantly southbound (i.e. from the mainland to Hong Kong) as Chinese investors have looked to diversify investment.** This is in part due to the falling RMB, but in addition full utilisation of the QDII scheme (outbound investment quota scheme) has meant that excess demand has spilled over to the connect. *Aggregate use* of the SSC has nonetheless largely fallen short of quota limits (see Figure 1).

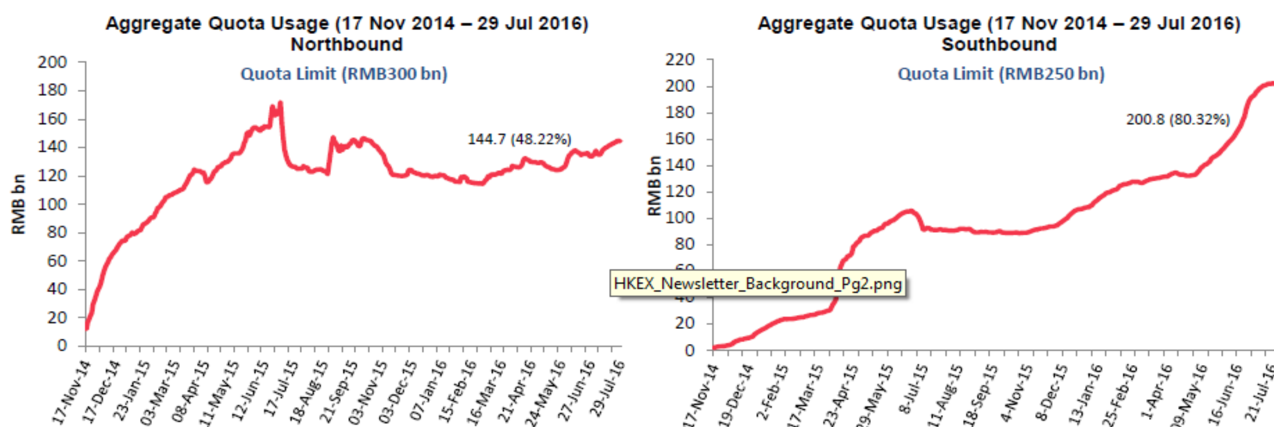

Figure 1: Northbound and Southbound Aggregate Usage; Source HKEX

4. **Growth in Northbound investment has been limited.** This is in part because the A-share index consists of heavy industrial companies which have been hit hardest by the Chinese slowdown. Trading levels have also flattened due to China's stock market volatility over the last year and subsequent government intervention – including lock up periods on divesting share holdings.

5. **Whilst mutual fund and hedge fund managers have continued to invest in the Shanghai Stock Exchange, greater uptake has been limited by rules on short selling.** Whilst the stock connect rules formally allow for shorting of mainland stocks, stringent qualifying requirements rule out the custodian banks, fund managers and major institutional investors who would provide the liquidity for trades. Take up of the scheme has also been hampered due to the complexity of the legal vehicles used to purchase shares through stock connect and questions over the legal protection of beneficial ownership.

6. **Southbound flows have remained steady since the summer** accounting for around 11% of the Hong Kong stock market's turnover. Many expect this to grow with a decision by the China's regulators (September 2016) to allow insurance companies to participate in the scheme. In particular, they can launch wealth management products to make portfolio investments via the SSC thereby freeing up their QDII quotas for other outbound investments. Whilst southbound retail investment should continue to grow, the requirement for a RMB500m trading account remains a barrier.

7. **Arbitrage has not brought together the prices of dual-listed shares in Shanghai and Hong Kong.** In addition to limited two-way flows, this is likely also linked to different investor assessment of valuations and levels of liquidity in the mainland and Hong Kong markets. The differential currently averages at about 20% (as at end October 2016). In some cases, H-shares (i.e. traded in Hong Kong) can be significantly cheaper than this, making it highly unlikely that these stocks will trade in the northbound route.

<u>Shenzhen-Hong Kong Stock Connect</u>

8. **After over a year of delay, the Shenzhen-Hong Kong Connect (SZSC) opened on 5 December, opening up a new investment channel into the Chinese market.** The 880 stocks available on the Shenzhen exchange are capitalised at RMB 15 trillion, nearly three-quarters of the exchange's total capitalisation. In contrast to the Shanghai exchange these firms represent some of China's youngest and most dynamic companies in the IT, science, manufacturing and health care sectors.

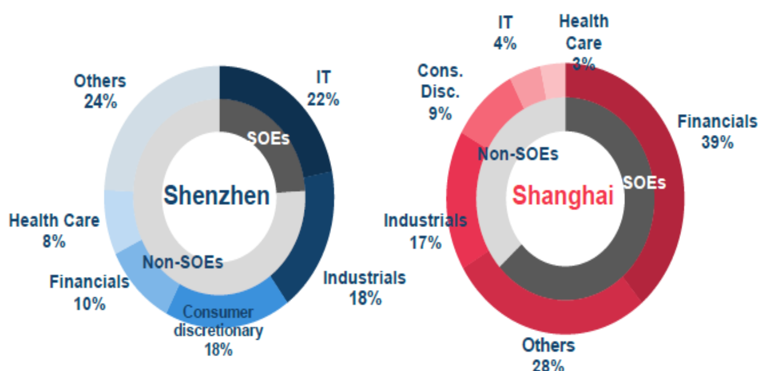

Figure 2: Breakdown of market cap by sector and ownership structure; source HKEX

9. **SZSC offers investors a higher yield alternative to Shanghai's blue-chip stocks with typical annual returns potentially as high as 25%** (in contrast to SSC's average yields of 12%). In the early weeks of trading, southbound *daily flows* have been consistently weak at between RMB 400-500m. Northbound, volumes rose sharply following opening of the scheme and have since stabilised with daily flows of approximately RMB 1.5 billion.

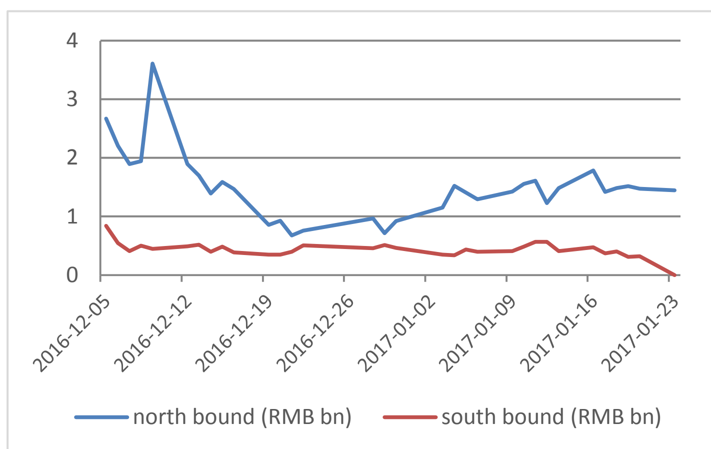

Figure 3: Daily trading volume on the SZSC since launch; source WIND

Notably, and in contrast to SSC, northbound flows are larger than southbound. However, fund managers' limited familiarity with stocks listed in Shenzhen, a 30% limit to foreign ownership of free floating shares, and high price/equity ratios for Shenzhen listed A-Shares (43 times) compares to Shanghai (15.6) have hindered growth.

Mutual Recognition of Funds

10. **This scheme allows Hong Kong and Chinese fund managers to passport their compliant local funds to retail investors in Hong Kong and China.** Given the huge opportunity presented by the retail Chinese market, there has been strong interest in the scheme from funds in Hong Kong since it opened in July 2015.

11. **However, the CSRC has approved only seven Hong Kong domiciled funds to date and the scheme has not yet lived up to high expectations.** Barriers for new entrants include the requirement for active management of funds in the home jurisdiction, establishment for over a year, and a fund size of at least RMB 200 million.

12. Northbound activity (confusingly this refers to Hong Kong products sold to mainland China investors, and implies a southward flow of funds), has been hampered by the limited number of branches available to mainland investors and a lack of experience amongst local banks in promoting funds to potential investors. Of those funds approved by the CSRC, JP Morgan's Asian Total Return Bond Fund has been dominant, capturing the majority of investment (over 90% from mainland China).

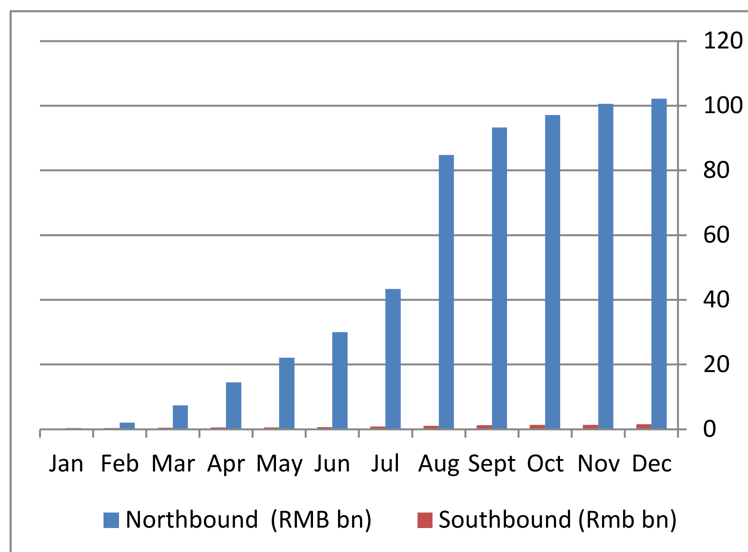

Figure 4: Monthly net MRF activity in 2016; Northbound indicates scale of Hong Kong MRF products available China, Southbound indicates scale of China MRF products available in Hong Kong; source SAFE

13. **Despite these limitations, northbound activity (i.e. scale of Hong Kong products available to mainland China) is still far greater than southbound (i.e. scale of mainland China products available to Hong Kong)** – see figure 4. This implies much greater southward flow of funds from mainland China to Hong Kong than vice-versa. At the end of December 2016, net flows from China to Hong Kong totalled over RMB 10 billion – 67 times larger than the net inflows (RMB 152 million).

Free Trade Zones (FTZs)

14. **China's FTZs have historically been used as for pilot initiatives on capital market connections, with a 'negative list' approach designed to open new sectors to foreign investors.** FTZ accounts, cross border loans, cross pooling and the Wholly Foreign-owned Enterprises (WFOE) scheme are all positive reforms which seek to open capital accounts to overseas investment.

15. **In January 2016, PBOC issued a notice permitting cross-border financing pilot programmes across the Shanghai, Guangzhou, Tianjin and Fujian FTZs.** Six Hong Kong fund managers are reported to be actively exploring new opportunities in Shanghai's FTZ with a view to establishing feeder fund operations through satellite offices in the city using the WFOE scheme. These operations would look to invest onshore, channelling Chinese investment into China-focussed portfolios managed by Hong Kong-domiciled funds. This could provide greater flexibility

than the MRF mechanism and could become a platform for international fund managers to establish themselves in the Chinese market. However there remain concerns over IP and knowledge transfer and requirement to limit investor numbers to 100 thereby excluding the mass retail market.

16. **Recent announcements from the Shanghai Financial Service Office to issue RMB-denominated bonds** totalling $443 million is also expected to attract some interest from Hong Kong and international investors as municipal and green bonds go on sale during 2017. Hong Kong already hosts a regular series of issuances of Ministry of Finance bond issuances, helping to build a yield curve in the market and provide a route for back flow of RMB. There is potential to also expand to municipal bond issuances in the Hong Kong offshore market.

17. **The Mainland and Hong Kong Closer Economic Partnership Arrangement (CEPA) is also being used to good effect by foreign companies to establish an effective presence in FTZs.** A notable example has been HSBC's agreement with the Shenzhen Qianhai government to establish the first majority-owned joint venture (JV) securities company in China (in which they have a 51% stake) although final CSRC approval is yet to be granted.

Prospects and next steps

18. **Trading volumes remain some way short of quota limits providing headroom for new investors to access China's capital markets and for Chinese investors to continue to diversify their portfolios through the existing channels.** There remains a risk however of tighter capital controls, potentially impacting growth and uptake of investment schemes with many northbound investors concerned about the ability to repatriate profits. The two connect schemes however could stand to benefit from investors seeking to diversify given the "closed-loop" nature of both initiatives, with proceeds of stock sales paid back to investors through separate clearing and settlement systems at each end of the Connect.

19. **The opening of the SSC and the prospects of additional investment channels raises the prospect of Chinese A-Shares' inclusion in the MSCI Emerging Market Index**. With over $100 trillion worth of assets tracking the MSCI's Indices, this could lead to a gradual but significant increase in equity investment in China over time by as much as $360bn according to China International Capital Corporation.

20. **Hong Kong Stock Exchange and Hong Kong Monetary Authority have indicated that an exchange-traded Bond Connect scheme is also in the pipeline**. This would be an important step towards improving infrastructure and easing international investment into China's bond market, the third largest in the world. Despite opening the bond market to all foreign private investors earlier this year, international investors still only account for around 2% of all investment. In the opposite direction, given strong Mainland demand for foreign fixed-income products, we can expect strong southbound flows into Hong Kong's $400 billion bond market.

21. **An extended 'primary equity' model of the existing Stock Connect schemes is also being developed by the Hong Kong Stock Exchange.** This would allow investors in Hong Kong and mainland China to subscribe to IPOs and new share issuances in the two markets. This would extend the investor base and would be welcomed in Shanghai and Shenzhen where more than 800 hundred companies are waiting to list, and in Hong Kong bring greater liquidity and a pricing boost in what was 2016's largest IPO market.

22. **Initiatives to connect mainland markets with Hong Kong also create a path for closer connection between China and other international markets including London.** As well as being the second largest RMB centre in the world and largest RMB trading centre, London offers Chinese investors enormous international opportunities to diversify internationally. Capitalising on those opportunities, the London Stock Exchange is currently working with the Shanghai Stock Exchange to develop a UK-China stock connect scheme.