MARKET INSIGHTS

Market Bulletin

April 13, 2018

PBoC to push financial market opening with a concrete timetable

In brief

China’s new People’s Bank of China (PBoC) Governor Yi Gang announced, during the annual meeting of the Boao Forum, to further open up China’s financial industry to attract foreign capital and revealed extra details regarding the financial opening up that was first mentioned in November 2017.

The new policies follow three key principles:

1. While foreign firms would enjoy the same benefits as domestic firms during the pre-entry stage, the government will operate a negative list* management at the same time.
2. The pace of opening up would proceed in accordance with reforms in China's exchange rate mechanism and capital account opening.
3. The importance of preventing financial risk during opening up would be emphasized.

Governor Yi noted that differentiated regulation could remain in sub-sectors, but the overall strategy is to give equal treatment to domestic and foreign investors.

KEY FINANCIAL SECTOR OPENING MEASURES ANNOUNCED BY GOVERNOR YI INCLUDE:

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Implementation deadline: June 30, 2018, unless otherwise specified:

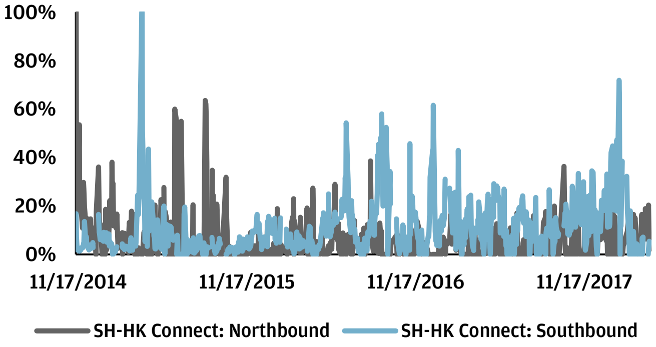
1. **Mainland-Hong Kong stock connect**: Quadruple the daily quota starting on May 1. In particular, for both Shanghai-Hong Kong stock connect and Shenzhen-Hong Kong stock connect, the daily quota will be quadrupled to renminbi 52bn/USD 8.3bn for Northbound and renminbi 42bn/USD 6.7bn for Southbound, respectively (from current renminbi 13bn/USD 2.1bn and renminbi 10.5bn/USD 1.7bn). So far, the market has rarely utilized the daily quotas—none for the Shenzhen-Hong Kong stock connect and only one day on Northbound (November 17, 2014) and two days on Southbound (April 8-9, 2015) for the Shanghai-Hong Kong stock connect (refer to Exhibit 1 and 2 on the next page).

*The negative list refers to the list of sectors and businesses that foreign companies are not allowed to invest in. Foreign companies can freely invest in any businesses outside of the negative list. The Chinese government has promised to revise and shrink this list in 1H18 so as to broaden market access for foreigners. The negative list was first introduced in the free trade zones, but it was still a big list and covered many sectors, including financials. President Xi and Governor Yi both mentioned that the list will be finalized with narrower coverage and will be applied nationally.

The market has rarely fully utilized the existing daily quotas for Shanghai-Hong Kong connect

EXHIBIT 1: UTILIZATION RATES OF THE SHANGHAI-HONG KONG CONNECT

PERCENTAGE

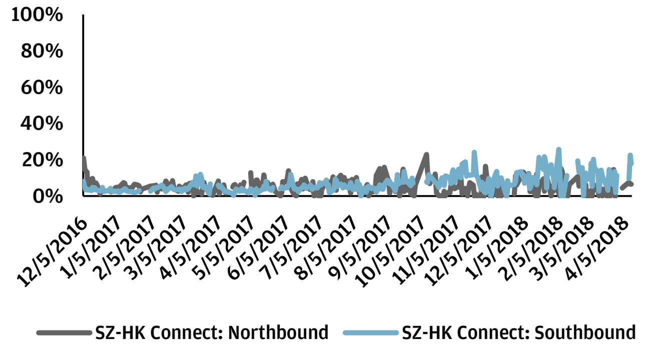


Source: CEIC. Data are as of April 12, 2018.

The market has never fully utilized the existing daily quotas for Shenzhen-Hong Kong connect

EXHIBIT 2: UTILIZATION RATES OF THE SHENZHEN-HONG KONG CONNECT

PERCENTAGE



Source: CEIC. Data are as of April 12, 2018.

Impact: The quota lifting was bigger and came sooner than expected. However, this should improve accessibility to the A-share market and make MSCI more comfortable with adding more A-shares to its indices and raising the A-shares' inclusion factor. The impact on the overall A-share market should be limited as the existing quota is underutilized. Yet, it could be fairly meaningful for the limited numbers of A-shares that are typically favored by offshore investors. In particular, the quota lifting may attract sentiment-induced flows. The increase in quota should also provide enhanced flexibility in the short term to support heightened international activity around the upcoming MSCI A-shares inclusion as well as longer term.

The MSCI commented yesterday that it welcomes the quota expansion, and the A-share inclusion will happen as scheduled. Recall that the first phase of the MSCI's A-share inclusion, which was announced at the MSCI's June 2017 review, will be implemented beginning June 1 (2.5% inclusion factor at the beginning and 5% by September 3, initially covering 232 A-shares). The next MSCI review is scheduled next month, in May 2018. After the review, it is possible that the MSCI may decide to raise the inclusion factor and expand the number of A-shares in its indices, to be phased in over the next one or two years.

2. **Banking sector**: a) To cancel the cap on foreign stakes: foreign banks would be allowed to own up to 100% of China banks and to set up their subsidiaries and branches without restriction while being treated equally with domestic banks, and b) Foreign banks would also be allowed to set up wealth management or asset management subsidiaries to manage banks' off-balance-sheet assets without ownership limit.

3. **Non-bank financial institution, such as securities, fund management, futures and life insurance**: Lifting the foreign ownership cap to 51% (from 49% currently) and abolishing it completely after three years. Note that the pace of removing the foreign ownership cap for insurance companies is faster than the original plan of the five-year period that was announced following U.S. President Donald Trump's visit to China last November.

4. **Securities/brokerages**: To cancel the requirement that its domestic joint venture partner must include a securities company/brokerage.

5. **Insurance sector:** Allow eligible foreign investors to establish insurance brokerages and assessment businesses in China.

6. Enlarge the business scope of foreign capital backed insurance brokers, allowing them to enjoy the same benefits as domestic insurance brokers.

Implementation deadline: end-2018, unless otherwise specified:

1. Encourage foreign investment in financial sectors, such as trusts, auto financing, financial leasing, consumer loans, etc.

2. No foreign ownership cap in banks' newly established wealth management companies or asset management subsidiaries.

3. Enlarge the scope of business for foreign banks, e.g. credit card, payment, settlement, etc.
4. Remove all limitations on joint venture securities companies/brokerages, allowing them to enjoy the same benefits/business access as domestic securities companies/brokerages.
5. Remove the requirement of establishing a two-year representative office for foreign insurance companies before they can officially set up an insurance company.
6. **Shanghai-London Connect:** Companies from the two countries will issue global depository receipts to list in the counterparty's exchange, different from the mainland-Hong Kong connect.

Overall, the execution timetable is earlier than what the market expected, and this shows the government's determination to implement financial reforms. Governor Yi also added that China will not use renminbi depreciation as a tool to confront trade tensions. He attributed the U.S.-China trade imbalance to structural and macro reasons.

Investment implication

The opening up measures highlight China's pro-globalization stance on the back of the trade tension between China and the U.S. This move is also part of a series of efforts around liberalization of China's capital markets. The new policies underscore the government's commitment to push through financial reform, which should bode well for the financial sector development in the medium to long run.

Foreign banks and non-bank financial institutions will enjoy a more level playing field after elimination/loosening of the existing restrictions. We expect overseas financial institutions to expand their businesses much faster than before. Having said that, due to the large size of their Chinese competitors, even though growth of overseas financial institutions could be quite rapid, the impact on the whole industry is likely to be limited.

On the China macro front, we continue to expect a relatively stable outlook, with a mild cyclical downturn in the middle of the year. The ongoing trade dispute will likely create increased levels of market volatility. Being more active in understanding a portfolio's potential exposures to the companies and sectors most likely to feel the heat from this dispute could help the individual investor mitigate some of this volatility.