Expert perspectives on China’s capital markets
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Foreword

Mark Boleat
Policy Chairman, City of London Corporation

In order to demystify the recent and current changes affecting China’s capital markets, the City of London has collected short commentaries from leading Chinese financial sector experts – including members of the City of London’s Advisory Council for China and other key stakeholders – based on their unique perspectives and their expectations for the future. We believe that encouraging two-way dialogue is vital to the development of global financial markets and that it is through the exploration of practitioner views that we can work together to share their experiences and build more effective and secure global capital markets.

Capital markets in general are an important part of any financial system as they create the means of investing savings and raising capital, thereby promoting overall economic growth. By providing new and diversified channels for investment, they can also play a substantial role in boosting research and development and raising employment levels. Capital markets offer institutions an alternative source of financing, particularly for small and medium sized enterprises (SMEs) who often find it difficult to access traditional bank funding. Financial centres with well-functioning and deep capital markets offer investors more choice as to how and where they invest, increasing their global competitiveness.

Given this significant role that capital markets play within the financial system, it is unsurprising that they are affected by a wide range of factors at the domestic, regional and international level. Across Europe for example, there has been much discussion in recent months over how best to support further growth of the region’s capital markets as a whole. Earlier this year the European Commission unveiled proposals for a Capital Markets Union, setting out a plan to create a single market for capital through integration of markets across the European Union’s 28 member states. Although ambitious, expectations are high for an eventual agreement and this topic is expected to dominate much of the European financial sector agenda in the near future.

Efforts to develop deeper and more efficient capital markets extend far beyond Europe however, and although until now most of the lessons learned have come from either the US or European model, the world is beginning to see a number of markets develop in other locations. A number of Asian markets are dedicated to opening up their economies and in line with this are developing their own models and rules to accommodate their specific needs and rapidly expanding markets. As part of this, we are seeing new capital markets develop and the widening of existing channels to encourage depth and offer new opportunities to corporates and investors.

Capital market reform is particularly evident in China, where it is being fuelled by an emphasis on market liberalisation and led at the highest level of government and as initially laid out in full within the State Council’s 12th Five Year Plan for the development and reform of the financial industry. International investors agree that China’s markets offer unparalleled potential, though its size, speed of development and complex regulatory and market reforms mean few outsiders have a detailed understanding of either the existing funding opportunities available or their true potential. I am confident however that this will change with time and most importantly, through increased engagement with industry participants in China.
The Chinese financial industry has been facing various new changes due to internal and external environmental factors. From changes in macroeconomic controls to the formation of market-oriented interest and exchange rate mechanisms. From the rapid expansion of direct financing to the rise of internet finance. From the changes in customer demands to fierce horizontal competition. In order to deal with this radically changing environment, the Chinese financial industry needs to accelerate its innovation and make new breakthroughs. This can be achieved by addressing the following aspects in the following ways.

First, development in internet finance, which following the trend of increased IT reform in the technology age, is needed. Internet financial activities, such as third party payment systems, mobile payments, peer to peer lending and crowd funding have been rapidly developed in the past few years in China. As a new business model for the financial industry, internet finance should not receive resistance or rejection from financial institutions. Instead, we should embrace it and welcome the new era together with this new business opportunity. The Internet brings advantages in information collection, data processing and overall customer response strategies, which financial institutions can enhance with their outstanding existing skills in in-depth customer service and risk management. Integration of the two on the basis of complementary advantages is a must for the development of the financial industry in China.

Second, a more scientific approach to finance is needed to improve the value of economic growth. To achieve sustainable and healthy growth of the Chinese economy, we need to accelerate development, continuously optimise the economic structure and improve the value and quality of economic growth. The vigorous development of innovative SMEs can effectively balance the speed, value and quality of economic growth: essential for achieving the overall objective. To this end China is accelerating the establishment of a multi-layered financial market system that meets the demands of innovative enterprises and tries its best to build a diversified financial industry model, which includes commercial banking, securities, insurance, venture investment and industry investment funds.

Financial institutions are also accelerating the exploration of effective scientific financial operating models with an aim to providing innovative enterprises with integrated financial services solutions covering fundraising, financial advisory services, cash management and investment. All using innovative risk control models, product systems and services models.

Third, the development of green finance that boosts the sustainable development of the environment is needed. Green finance has already become a gradually developing trend across the world. The Chinese financial industry is also facing huge opportunities for developing in this aspect. Particularly in line with China’s 12th Five Year Plan which sees the green industries, such as renewables and new energy source solutions (including energy saving schemes), environmental protection, new biological materials, defined as ‘strategic emerging industries’ and receiving great support. According to statistics, the investment demand for environmental protection will only reach RMB 500 billion in the coming five years in China. However, in future financial institutions in China will take more advantage of the great opportunities generated by the government’s support and there will be increasing investment from enterprises into the environment protection industry. Expanding for example also into new markets for pollution treatment, energy saving and emissions reduction, renewable energy and advanced environmental protection services. We will also see the development of new financing models for green lending and Clean Development Mechanism (CDM) projects. Financial sector institutions at the same time will offer more customised green retail products to meet the specific green needs of the customer, according to social and global trends.

Lastly, there is a need to increase the amount of...
crossborder finance from China’s economy. In future the liberalisation patterns of China will be further expanded with the Chinese government-led “going out” strategy deepening and China’s economy playing an increasingly significant role in the world. A vast, liberalising economy needs the support of a strong global financial system and crossborder finance will be carried out in larger volumes. In future with the acceleration of the renminbi’s internationalisation, the “going out” of Chinese enterprises, residents and capital will be similarly accelerated.

Therefore, crossborder financing for China is entering a significant, strategic stage in its development. It is foreseeable that institutions will march forward into global financial markets, in a common direction and increasing the levels of innovation of China’s financial institutions as a whole. This will include, for example, the establishment of new crossborder platforms with multiple channels and functions; and the provision of overarching control over domestic and overseas financial demands of their “going out” customers. This in turn will mean the development of more competitive crossborder financial products and provide the impetus to financial institutions for continuously improved, integrated service systems for crossborder finance.
Recognising the new stage and adapting to the ‘new normal’

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The global financial crisis starting at the beginning of 2007, ended the last round of long-term boom since the end of 1980s, and the global economy entered the stage of extended structural adjustment.

Nowadays, although the debt crisis, fiscal crisis and economic crisis of America has stopped getting worse, it’s still far away from normal growth track; or, as Larry Summers, the former treasury secretary of America, said, America now is at the stage of “secular stagnation”. In Europe, although the Union has not fallen apart due to debt crisis, the economic crisis there has shown a persistent tendency. In Japan, although the three major initiatives advocated by Prime Minister Abe were implemented at the same time, the country cannot effectively get out of the dilemma of deflation which has lasted for over 20 years and the government debt crisis and economic crisis will continue.

The emerging economies, although they experienced a period of exciting and high-speed growth during the early stage of the crisis, now have mostly got into the troubles of economic slowdown, deterioration of international balance of payment, capital outflow and depreciation of home currency in exchange rate fluctuation, as generally the savings and foreign exchange “dual gap” mechanism in such economies have not been rectified. In such a mess, a vacuum appears in global governance. When facing complicated non-conventional challenges, the traditional global governance mechanisms and their organisations, such as the UN or the IMF, are just at their wits end. They even cannot effectively cope with all of the conventional challenges. The new governance mechanisms arising from the crisis, such as the G20, worked well for a time; however, when the crisis situations eased off a little, they were immediately hijacked by all kinds of narrow state interests and could not continue their glory days. In a word, the global economy now has entered a new stage. The low and volatile economic growth, excessive global liquidity, changing commodity prices, prevailing trade protectionism and strained geopolitics constitute the new normal of the current global economy.

Under the backdrop of globalisation, no state can stand aloof and China is no exception. The Chinese economy entered down the track of “structural slowdown” from 2009.

In term of changes in the economic structure, as the labour productivity in the service industry of China is much lower than that in the manufacturing industry, when the economic structure shifts from manufacturing dominated to service industry dominated, the total labour productivity in China will surely decrease, which will lead to the decrease of the economic growth rate. In term of production factors, the decrease of the growth rate of investments in labour and capital, which is appearing against the backdrop of slow technological advancement, will also lead to the decrease of the economic growth rate in China. At the same time, as the aging of the population becomes increasingly serious, the participation rate of in the labour force decreases and the scale of migration of the rural population into urban areas tend to decline. This, coexisting with the friction caused by widespread and individual unemployment will cause the rigid increase of labour costs.

The demand side changes also point to the new tendency of growth. Since 2006, the rate of contribution of domestic consumptions for economic growth had been increasing steadily. However, after reaching the peak value of 55.5% in 2011, it kept declining and reached 50% in 2013. During the same period, the rate of contribution of external demands for economic growth tumbled even more drastically and was negative for three successive years after 2010, reaching a new low of -4.4% in 2013. On the other hand, the rate of contribution of investments kept increasing in the seven years from 2006 to 2013, resulting in a climb of over ten percentage points. As shown in such figures, to support the economic growth in our country with a reasonable demand structure, great efforts have to be made.
The above changes on the supply side and demand side jointly form a new stage of economic development in our country. Therefore, a sub-high growth with the average rate of about 7.5% also becomes the new normal of the economy of China.

The slowdown of economic growth is not a bad thing for China, as it provides genuine pressure and driving power, urging us to make up our mind for the full transition onto the track for sustainable development to improve economic performance, pay more attention to quality and sustain our country through innovation. The economic growth with a slightly slower speed but increasing quality and performance is just the goal we have been pursuing for years.

The targets for transition can extend in several directions. However, in summary, we are pursuing non-exaggerated growth. In China, the exaggeration in economic growth is mainly reflected in low efficiency, of which the main characteristics are high costs and excessive production. In term of cost, our economic growth in the past had been sustained with high investments equivalent to a half of the GDP and with net exports close to 10% of the GDP. This alone makes the cost of economic growth in China among the highest in the world. In terms of production, in the long-term and for large-scale investments, it's common that no production capacity is formed or newly added production capacity is left unused, which becomes ever more serious. As a result, the effective supply decreases relatively and the situation for over capacity becomes increasingly grim.

When facing the new normal in both domestic and foreign economic developments, as a countermeasure China should speed up the transition of its mode of economic development and the adjustment of its economic structure. The decision made at the Third Plenum of the 18th Central Committee of the Communist Party of China showed China’s definite determination for reform. In terms of driving power for the transition, we will pay more attention to the motivation of corporate and market powers; in term of economic policies, we will break the inveterate habit of “bailout” and “stability maintenance” and make efforts to build a long-term mechanism with enhanced efficiency and growth potential.

The governments of all countries have recognised that, as the global economy enters the stage of transition with long-term structural adjustments, reform and innovation will be the only way out. We can even say, the country with the deeper understanding, the more complete strategies, the higher level of determination and the better effects for creating this will go ahead of others in terms of future global development. From this point of view, there is no doubt that China is among the top of the world again.
4. China’s financial restructuring

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(Adapted from the original published by the HKS China Society in March 2014)

China’s financial system and financial markets have undergone profound changes since the reform and opening of the market initiated in 1979. Currently, the main elements and structures have been established as well as a relatively complete layout for the financial system. Its peculiar structure is a reflection of the transition from financial repression in a planned economy towards a fully functional financial market in a market economy. The financial sector has developed slowly, lagging behind the real economy. For example, banks are the predominant players in the financial system, the bond market is less developed, and interest rates have yet to be fully liberalised.

Recent events in the Chinese financial sector have drawn attention from around the world, such as local debt problems, shadow banking, corporate bond defaults, rushed withdrawals of money by depositors from certain banks. This pessimistic climate has been reinforced by the economy’s slowdown since the beginning of 2014. Many people believe that China is on the verge of financial crisis. In my view it is not yet, but we have to address the roots of the problem and find solutions as soon as possible before a systemic crisis takes place.

Below, I specify the institutional issues that, in my opinion, underlie China’s peculiar financial structure as well as the financial problems as they appear to us (they are phenomena with substance, but people tend to talk about phenomena rather than their substance).

Interest rates have yet to be liberalised

Until recently, interest rates in China have been fully controlled. In the late 2000s, China’s central bank allowed the loan rate to float within a range and then to float fully in the first half of 2013. Deposit rates are still controlled.

The interest rate policy of controlling the rates and keeping them low has been rooted in China’s development strategy since the 1950s, even after reforms were enacted as has been widely seen in emerging Asian countries. The policy can be justified because it really helped the country to concentrate the financial resources needed to survive difficult periods of time and achieve rapid economic development.

This policy was not only meant to support state-owned enterprises (SOEs) but also to protect state-owned banks. Until now, banks have enjoyed a 2-3% spread and therefore have little incentive to establish a fee-based business or develop other financial services. In this way government policies have heavily favoured SOEs and state-owned banks for a long time.

As a result, depositors (consumers) tried to shift their money toward alternative investments. In the 1990s, money was transferred to the then recently established stock market and government securities futures market. In 2000, money started moving into the real estate market. In 2008, the government cracked down on the overheated real estate market, and money started to migrate to wealth management. These unexpected money shifts from traditional banking sectors to other financial sectors have triggered one market boom after another, causing overheating as well as government intervention.

Government interventions turned out to be less effective due to the institutionalised nature of the issues being targeted. In the mid-1990s, the government intervened in the overheating stock market and in 1995, the State Council closed the government securities futures market. In the late 1990s, the government intervened in the corporate bond market and in 2008 the government intervened in the real estate market. In 2012 intervention was taken as the government tried to rectify shadow-banking problems.

The hunger for investments is reflected in both banks’ and local governments’ initiatives

Major state-owned banks have now been transformed into corporations, and most of them have been listed. Their corporate governance is less restricted than those of bank operations as the presidents of banks were not nominated by boards of directors but by the government.
Banks have been regulated by administrative measures such as credit ceilings and deposit-to-loan ratios since the 1990s, and especially in the 2000s. Due to their peculiar corporate governance, they are incentivised to boost assets rather than maximise shareholder returns. This strict regulation encourages financial institutions to circumvent rules, develop new products and find new business opportunities. As a result, their off-balance sheet business has developed. These dealings are made mainly through less regulated trust companies and money market funds. SOEs have incentives to borrow from banks due to soft budget constraints, and money tends to be cheap because banks feel in terms of responsibility they are safer giving money to SOEs rather than to SMEs and private companies.

The money that moved away from the banking sector has boosted investment through other channels. Money that moved to the corporate bond market, money market funds and trust companies has also been less controlled. This is due to the fact that bank loans have been controlled through quotas and the cost and return of money tends to closely affect the market outside of the banking sector.

The initiative to invest is not only coming from the banking sector, but also from local governments’ hunger for capital due to the central government’s performance evaluation that focused on GDP growth. Local governments establish platforms to serve as borrowers on their behalf. In addition, local governments have established offices under their own jurisdictions to coordinate finances from different sources.

**Real economy vs financial sector**

It is obvious that regulated interest rates, the banking sector’s administrative framework, the underdeveloped corporate bond market and money market funds are the roots of many of China’s financial issues.

While we are focusing on the financial system and financial markets, it is important not to lose sight of economic fundamentals, and especially consumer behavior.

Since the beginning of the 2000s, there has been a boom in domestic savings. Savings ratios went up to over 50%. Capital contribution to GDP growth moved up to 70% and corporate savings increased more than private savings.

Perhaps the urbanisation programme and the increasing demand for infrastructure have changed the investment behaviour of banks and local governments, and the emerging middle class and IT revolutions have changed consumer behaviour. These are also factors that relate to financial sector issues.

**The segmentation of financial markets**

Marketplaces are artificially divided into the interbank market and stock exchange market. The interbank is a money market and the interbank bond market is a capital market. But the two functions have been mixed up and have given rise to a malfunctioning so-called ‘interbank market’.

One defect is the homogeneous behaviour of market participants, which is the main reason for liquidity squeezes. As a result of this market segmentation, the stock exchange has lacked liquidity and the interbank market has been traded on less frequently. As a result there are two different prices for the same credit or product.

**Overlapping jurisdictions and lack of supervision**

Currently, there are three supervisory bodies within China’s capital markets’ regulatory framework: the China Banking Regulatory Commission (CBRC), China Securities Regulatory Commission (CSRC), and China Insurance Regulatory Commission (CIRC). These regulate the banking sector, stock sector and insurance sector respectively.

The bond market is subject to overlapping jurisdictions: NDRC has the authority to examine and approve enterprise bonds; CSRC is in a position to regulate the stock exchange’s bond market; the People’s Bank of
China (PBoC) firmly controls the interbank bond market and the Ministry of Finance (MoF) runs the government securities primary market.

In addition to this overlap, there are vacancies with respect to shadow banking related institutions, such as trust companies and money market funds. As a result of the segmented regulatory framework, there is no individual institution to work out and lead a financial development programme in the long run.

**Lack of an investor services industry**
In the 1990s, two rating agencies in China were established; there were the associations of dealers, such as the government securities dealers’ association in 1993, and the traders association, which developed later in 2003. However, investor education has attracted less attention from regulatory authorities. Deposit insurance systems have been discussed but not yet fully established.

**Monetary policy has been less well applied**
There has been little coordination between fiscal and monetary policy since 1994. For the most part, fiscal policy has been expansionary, but monetary policy has been ambiguous: the word used is “steady”. This is to say that it sends ambiguous signals to the market, and leaves itself more room for policy changes. The Ministry of Finance has rarely issued short-term treasury bills, and pays little attention to the shape of the treasury yield curve.

Because interest rates have been controlled and are normally lower than market rates, the treasury yield cannot serve as a benchmark. This gives rise to interesting phenomena: banks use the deposits they received to invest in government securities and China Development Bank bonds to get risk free arbitrage revenue. It is important evidence of market malfunction and inefficiency.

The central bank is used to absorbing liquidity increases as a result of foreign exchange reserves by repurchasing central bank paper, but is less sensitive to the shortfall of liquidity. In addition, the central bank had fewer instruments before it introduced its Standing Liquidity Facility (SLF) and even now these ‘discount windows’ have been used less frequently.

Banks also have no flexibility to increase multipliers such as the credit ceiling, loan quota and deposit-to-loan ratios when there is a shortfall of liquidity, and banks are incapable of increasing their own liquidity.

In summary, the inefficiency of the financial market and the fragility of the financial system in China are more likely to incur financial risks. Debt crisis is a potential risk and could occur in areas of the corporate bond market, local government debt and shadow banking. These reflect the transitory nature of the financial system and market, and the contradiction between going forward and going backwards.

However, China’s financial sector is more robust than it was 10 or 20 years ago. Banks had non-performing loan (NPL) ratios in the 1990s as high as 30%. After writing off NPLs twice, banks have improved their financial strength and performance, their risk management and IT systems. Current NPL ratios are only 3% or less. Local government debt is RMB 18 trillion, about 60% of GDP and there is no imminent danger of systematic defaults and debt crisis.

Financial issues have to be put in the context of real economic movements. The roots of financial problems have to do with the structure of financial markets, which has to do with the financial system: this in turn has to do with the financial regulatory framework. Financial restructuring should focus on the issues mentioned above, that is to establish a long-term financial development programme including fully liberalised interest rates, integration of regulatory authorities, marketplaces and improving the corporate governance of banks, SOEs and local governments so they work like corporations.
5. Proposals on the development of China’s securities market

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China’s securities market, starting from the establishment of Shanghai Stock Exchange and Shenzhen Stock Exchange, has a history of 24 years (by December 2014). Compared with the capital markets of countries with well-developed market economies, which have been developed for two to three hundred years, the securities market of China is still young. However, owing to the overall large scale and high-speed development of China’s economy over the past thirty years and especially the experience it has learned from many developed capital markets (especially that of America) since the very beginning of its development, the securities market of China has leapfrogged several development stages. After twenty years of rapid growth, the securities market of China has become one with advanced trading models and one of the largest markets by scale in the world.

In terms of trading models, the securities market of China adopted the method of all-electronic, centralised quotations and automatic matching upon its establishment. Both its trading speed and capacity are world leading. Paperless operations have been employed for stock certificates, a T+0 system was implemented for clearance and settlement (which has been changed to T+1 due to over-speculation) and a tier one custody clearance system for securities. With the rapid popularisation of the internet, trading orders and payments can be completed via internet and mobile internet terminals.

In terms of market scale, over 2,600 companies were listed on the two stock exchanges by the end of 2014, with a total market value of RMB 37 trillion, total annual turnover of RMB 74 trillion and maximum daily turnover of RMB 1.1 trillion; the highest in the world. The number of securities investment accounts has reached a total of 236 million. In addition, over 2,000 companies are listed on the New Third Board.

In terms of the structure of the securities market, there exists a multi-layered capital market covered by the main boards in Shanghai and Shenzhen and supplemented by Shenzhen’s SME boards, Growth Enterprise Market (GEM), New Third Board and over-the-counter (OTC) markets.

Though the securities market of China leads the global capital markets in terms of hardware and size, its operating quality and efficiency are not so satisfactory. There are two main problems. First, the stock index is not closely linked with the macroeconomy and thus fails to act as the leading indicator for economic trends. Secondly, the market has a poor financing capacity. Of the total amount of social financing in 2014, RMB 435 billion comes from the stock market, accounting for only 2.6%, whilst the balance of new bank loans is RMB 9.78 trillion, accounting for 59%.

The first important reason for the above two problems is that the investors in the securities market of China are mainly retail investors, whose turnover accounts for 85.37% of total turnover in the market and whose shareholdings at the end of the year accounts for 25.03% of the total market value. Among the existing institutional investors, due to problems in the system and short-term investment motives mutual fund and corporate investors are also engaged in short-term investments, which are highly speculative and no different to those of the retail investors. In my opinion, none of the large-scale securities markets in the world are sustained by retail investors, and nor can China establish a well-developed securities market based on retail investors. In order that the securities market can better exert its financing function and act as the leading indicator of macroeconomic trends, we must make efforts to develop long-term investors who mainly engage in value investing and can in turn promote ideas of value investing to others. For clarity, at present professional long-term investors mainly refer to social security funds, pension funds, enterprise annuity funds and insurance funds.

1 A national share transfer system for small- and medium-sized enterprises that was announced in 2013.
In order to foster professional long-term investors in the market, we should first provide corresponding preferential tax policies. In this way people participating in the pension funds, commercial pension insurance schemes and enterprise annuities should be given preferential policies for deferred individual income tax. Also as a second step, the capital gains tax on investment should be reduced or made exempt for those who hold stocks for the long-term.

Secondly, the threshold for market access should be lowered for professional long-term institutional investors. At present, all kinds of regulatory organisations (including the Ministry of Finance, the Ministry of Human Resource and Social Security, China Banking Regulatory Commission and China Insurance Regulatory Commission) apply rigorous restrictions on which financial products are allowed to be invested in, stipulated by the corresponding professional long-term investment institutions. It’s true that this approach is in part due to the fact that some institutional investors have made improper investments, leading to severe losses and seriously affecting the benefits of pensioners and policy holders. In my opinion however the correct way to handle this should be for regulatory organisations to reduce restrictions on types of financial products eligible for investment, while strengthening the supervision of governance structures and risk management of professional institutional investors, and by implementing a robust compliance reporting system for such institutions.

Thirdly, we should strengthen the governance structures for professional long-term investors, establish effective internal checks and balance mechanisms and accountability systems, and enhance their abilities in professional investment, risk management and internal control and compliance management.

Fourthly, we should provide more complicated, exclusive and higher-risk financial products for institutional investors, so as to facilitate the development of institutional investment as a whole. At present, most financial products in China are available for both individual investors and institutional investors. One of the characteristics of Chinese society is the preference in making your own investments, rather than commissioning institutional investors or other experts to manage funds for you. Therefore, the securities market of China has been dominated by retail investors for a long time. Now it is time with regard to the development of products for institutional investments, to look for example at the London market, which is experienced and can provide favourable technical support to help develop new products.

The overall problems with the Chinese securities markets can also be attributed to the poor governance of listed companies in China, especially the lack of fiduciary duty of the company management to the shareholders. There is no correct relationship between the principal and agent, which leads to a short-term commercial act, arbitrary change of main business, abuse and misappropriation of funds. In turn this can lead to negative effects for associated parties caused by long-term failure in dividend payments and poor quality disclosure of information. In such cases, it’s very difficult for Chinese investors to pursue value investments as the investors cannot determine which companies have higher values for investment. In particular, it’s difficult for them to make judgment on the medium and long-term investment value of such companies.

Corporate governance is a concept and approach originating from the Anglo-Saxons and a belief in the market economy, which is perceived to be quite different from the traditional moral ideas and approaches of China. In addition, the system features also restrict the functioning of many aspects of corporate governance.

In order to improve and enhance the governance of listed companies in China, we should first strengthen education and training for directors and managers of listed companies, so that they develop a firm belief that they should be faithful to their shareholders (ahead of their superiors or the government).
The willingness and ability of investors, especially long-term institutional investors, to take an active part in corporate governance should be strengthened, and corresponding mechanisms, including the class action system, should also be established. In addition to the changes above, the government should reduce their inappropriate intervention to allow enterprises to become real independent economic entities.

Finally, securities regulatory organisations should strengthen their supervision governance of listed companies and seriously investigate any acts carried out to the detriment of the interests of shareholders. In terms of market regulation, the system arrangement should be adapted more to meet the market’s needs, such as fitting the specifics of the issuing system and pricing mechanism, and the enforcement of related areas should be significantly strengthened.
Since the establishment of Shanghai Stock Exchange (SSE) and Shenzhen Stock Exchange (SZSE) in 1990, China’s capital market has taken momentum from the country’s strong growth and made remarkable achievements through a series of explorations and innovation. Especially, in the recent decade, further opening-up and innovation in the market enabled its leapfrog development.

First, the market’s size has expanded significantly
At the end of 2014, the total market value of all stocks in both Shanghai and Shenzhen markets hit USD 6 trillion, an increase of 56% year-on-year and ranking second in the world, only after America. This scale matches China’s position as the world’s second largest economy. Currently China has grown into the largest emerging securities market in the world and a major player in global capital markets.

Second, the market system has become increasingly sound
A multi-tiered market has been established with the main-board, SME board, growth enterprise board in Shanghai and Shenzhen and the National Equities Exchange and Quotations (NEEQ). By the end of 2014, there were 1,475 companies listed on the main-board, 732 companies on the SME board and 406 companies on the growth enterprise board. In addition, nearly 1,500 enterprises are listed in the NEEQ. Many leading companies and numerous large-scale ones are amongst those listed, enhancing the typical role of listed companies in the economy.

Third, the capital market’s functions have been strengthened
The development of capital market facilitates for transferring savings into investment and improving the flexibility of the financial system. The proportion of bank loans for non-governmental financing keeps decreasing. By the end of 2014, a total of USD 1 trillion has been raised from the stock market, greatly contributing to the economic transition and restructuring adjustment programme. Take the Shanghai market for example, where 169 listed companies undertook major asset restructuring procedures in 2014 with a total transaction amount of USD 21.5 billion.

Fourth, the market has been steadily opened up
Guided by the government’s ‘Going Global’ strategy, a large number of Chinese companies have issued stocks and been listed on exchanges in Hong Kong, Singapore, America, the UK, etcetera. By the end of 2014, there were 876 enterprises in total from mainland China listed in Hong Kong, raising a total of HKD 4.4 trillion and with a total market value of HKD 15 trillion, accounting for 60% of the total market value. A total of 127 Chinese financial institutions have obtained Qualified Domestic Institutional Insurer (QDII) licences, with a total investment quota of USD 83.3 billion. For foreign investment, 48 Sino-foreign joint venture fund management companies have been established in China with a foreign shareholding limit up to 49%. Eleven Sino-foreign joint venture securities companies have been established with a foreign shareholding limit up to 49%; 261 Qualified Foreign Institutional Investor (QFII) licences have been granted with a total investment quota of USD 66.9 billion and 95 RQFII licences have been granted with a total investment quota of RMB 299.7 billion. In 2014, the successful launch of the “Shanghai-Hong Kong Stock Connect” started a new era of two-way opening-up of China’s capital market.

Over the past 20 years, as the main board of China’s capital markets, the Shanghai securities market has been growing and expanding, effectively promoting continuous healthy economic development. It has become an important platform for China’s capital market in boosting reform, economic growth and harmonious development of society. At present, the market acts as an important barometer for China’s economic development. By the end of 2014, there were 995 listed companies on the SSE, with a total stock market value of USD 3.9 trillion, accounting for 65% of China’s stock market value.
In the next period, the SSE will seize the favourable opportunity to actively implement four major strategies focusing on stocks, bonds, derivatives and internationalisation, and promote the overall development of all businesses.

For the stock market, incremental reform will be the approach for development. Based on the main board, two additional boards – Main board Selection board and New Emerging Growth board - will be established to form a new multi-tiered market layout with differentiated developments. The Main board Selection board is mainly focused on large-cap, blue-chip enterprises and the qualified blue-chip shares in the original main board are included automatically; the new Emerging Growth board is mainly focused on high-growth enterprises with new technologies, products, industries and business models in new economic conditions. At the same time, different arrangements will be made for the different market boards in terms for example of issuing, listing, transaction, supervision, shareholder structure, corporate governance and operations.

For the bond market, based on the expansion of the pilot programme for corporate bonds, we plan to establish a corporate bond issuing system covering all incorporated enterprises, and solving companies’ financing difficulties, especially for SME and micro ones. In addition there will be exploration and subsequent development of municipal bonds, adding transparency of financing channels for the construction of new-type urbanisation. In order to provide new capital management instruments for commercial banks, we expect to see the development of innovative bond types such as perpetual bonds, mandatory convertible bonds, etcetera. We will integrate bond market resources within the securities regulatory system, enhance the market mechanism and develop the bond market between stock exchange institutions. In addition to the steps outlined above, the development will also benefit through cooperation with the Chinese government’s ‘One Belt and One Road’ strategy, by making full use of the policy benefits from the Shanghai Free Trade Zone (FTZ), by establishing an Asian bond market in the FTZ targeting both entities established in the zone and from overseas market, and by providing the full range of bond financing services for enterprises taking part in the ‘One Belt and One Road’ strategy to go global.

For the derivatives market, after a steady launch and smooth operation of the pilot exchange-traded fund (ETF) option, we will optimise supporting mechanisms and develop T+0 transactions, T+D transactions and lending transaction products. Efforts will be put into developing exchange traded futures and options, based on existing stocks and bonds models and establishing a diversified and innovative exchange market for derivatives.

Internationalisation is also a major focus. This includes promoting the internationalisation of existing investment products and – based on further optimisation of the Shanghai-Hong Kong Stock Connect – promoting the inclusion of A-shares listed on the SSE on global indices, such as the MSCI Index and FTSE Index. We will carry out research and the promotion or mutual recognition between Chinese and overseas fund products and exchange traded products. It also plans to promote foreign participation in China’s capital markets; expand scopes for QFII, QDII and Renminbi Qualified Foreign Institutional Investor (RQFII) schemes; increase investment quotas and upper limits; promote the steady opening of the domestic capital markets for direct investment by foreign individuals; and facilitating mainland individuals to invest directly into offshore capital markets in an orderly manner. SSE will still continue to promote further links between domestic and offshore capital markets, do further research to drive innovation and exploration of other forms of market connect mechanisms and promote the internationalisation of Shanghai securities market step-by-step.
7. **RMB internationalisation still has a long way to go**

**Xia Bin**  
Counsellor of the State Council of the PRC, Honourable Director General, Financial Research Institute, Development Research Centre of the State Council of the PRC

It has been 60 years since the founding of ‘New China’, however, real development of financial industry in China was hardly seen in the first 30 years, leaving China detached from the rest of the global financial system. In another way, China’s financial system is like an “orphan” in the global financial system. During the second 30 years – from the beginning of Chinese Economic Reform of 1979 to 2008 financial crisis – although China’s financial industry underwent rapid development, China was still not a positive “player” in the global financial market. Actually, the Crisis could be seen as two sides of the same coin for Chinese financial players. After experiencing the Crisis, more Chinese scholars came to understand how the world’s economic and financial system operates. China, at its critical moment of rejuvenation, was therefore much blessed to be given the ideal opportunity of participating in the reconstruction of the global economic and monetary system, thus embarking on a new round of financial development for the third 30 years.

When speaking of the crisis, I also want to remind my fellow citizen that, despite the trouble faced by the United States and the US dollar in 2008, and the fact that the renminbi (RMB) has been gradually winning favour in the global market, we must keep sober-minded enough to recognise that even if the RMB’s market position is improving – and getting increasingly closer to that of British pound, Japanese yen and other currencies – it is foreseeable that during the next 20 years or longer, the international monetary system will still be seen as one-polar system, which is dominated by US dollar, though its top one ranking might be undermined.

The further growth of China’s economy urgently needs to avoid and overcome negative results led by the irresponsible move and “Non Global Public Goods” of US dollar-led policy from time to time. Hence, Chinese currency RMB is obliged to become an international currency. However, Because of tough and slow process of China’s domestic economic reform and long-time strong US dollar policy, we must realise that the internationalisation of the RMB will not be accomplished at one step and is expected to be a long process. How long it will take depends on overall changes and competition of political, economic and military power of China, America and other economies in the world, and some unpredictable occasional events that may occur.

Looking into the future, we are confident that China will continue in promoting further RMB internationalisation, however, there will be no fixed schedule. RMB internationalisation process will be determined by both China economic reform and international financial situation. China’s recent economic reform shows that China is exploring different channels to promote the RMB internationalisation. The moves include: the launch of the Shanghai Free Trade Zone and the Shanghai-Hong Kong Stock Connect program; the support of offshore RMB Market and the expansion of the exchange rate floating band; the increasing currency swaps between People’s Bank of China and central banks of relevant countries. And all these measures were undertaken in a sensible and cautious way.

Further in my opinion, during the process of gradually promoting a market driven exchange rate and the liberalisation of the capital account, all relevant Chinese government entities should increase their focus on how to build a better mechanisms which enable the freer in and out flow of the RMB in capital market. This could also provide a unique perspective for observing and understanding overall financial institutional transformation in China.
8. The rise of the asset management industry

Katherine Tsang
Founder, Max Giant Limited

The year of the horse has ended. For China last year we did not expect to see the economy following the galloping horse by gathering speed and we were proven right. If there was a single word to describe China in 2014 it would be ‘change’, the same as what President Obama promised the Americans during his first term.

The current government under the leadership of President Xi recognises that after 35 years of growth at breakneck speed, the country is in dire need of a strategic cultural change and fundamental economic reforms. The Chinese economy is now transitioning to a “new normal”, as coined by the leadership, to manage expectations on the growth trajectory. We anticipate slower but more sustainable growth, alongside progress towards liberalisation through economic reform.

Now the year of the ram has arrived, we look forward to a more prosperous and fortunate outlook, as is promised by this Chinese zodiac sign. In my view this is particularly the case for the fortune-making industry, for example, the asset management industry. I believe China now offers unprecedented opportunities to asset management practitioners and investors not just in China, but across the world.

Depending on what measures one uses, we could claim that China’s asset management industry has actually already achieved tremendous growth in recent years. In terms of assets under management (AUM) whilst a decade ago the whole industry was around RMB 500 billion it now stands at over RMB 4 trillion, equating to an eight fold increase. During the same period, financial assets have grown from RMB 60 trillion to RMB 150 trillion with mutual funds’ share of the total growing from 1% to 4%. This growth has been matched by China’s overall development with GDP over the same period increasing tenfold.

From these numbers alone we can deduce that the industry’s potential for growth is huge, not to mention the opportunities still to be realised as a result of the substantial journey of economic reform China needs to undergo to fulfil President Xi’s expectations. These measures include, but are not limited to, financial markets liberalisation (e.g. liquidity, banking regulations, rates, capital accounts and forex), urbanisation, state owned enterprises (SOEs) restructuring and RMB internationalisation.

Each of these areas represents a monumental project that will change the DNA of China’s economy. They will alter the make-up and sustainability of the ecosystem and make China more ready to align itself with the established global financial market. We expect tremendous opportunities from each of the changes, which will impact prices across all asset classes. Given the size and importance of China globally and with Chinese asset managers currently numbering only a few, many types of stakeholders stand to benefit from this extensive reform programme.

Specifically from an investment perspective, the biggest opportunity emerges from the allowing of access to new groups of institutional investors. Institutional investors in China command over RMB 70 trillion in assets at the moment. They are conservative and many allocate more than 90% of their portfolio to cash and domestic government bonds. Their behaviour is attributed largely to earlier restrictive regulations which are changing in line with the government’s confidence in its ability to stay on top of the economic evolution as well as handle the new dynamics of a fledgling market-oriented economy. A good example is the change in the insurance industry’s regulations, which now have moved towards encouraging portfolio diversification. The China Insurance Regulatory Commission (CIRC) continues to issue guidelines that broaden insurance companies’ investment products choice. Similarly, the restrictions on firms’ overseas exposures have been relaxed to include 25 developed and 20 emerging markets.

The great news for fund managers is that insurers are allowed to outsource to authorised external asset managers. And hope is raised further from the marked increase in public servants’ pay as well as the relaxed rules governing their pension plans. We know that the National
Social Security Fund is under a lot of pressure to increase its return and despite its continued conservatism it is actively looking to relax investment restrictions to achieve better yield.

On the individual investor side, the growth of Chinese high net-worth individuals (HNWI) is still leading the world despite its latest slow-down. With this development the investment habits of China’s richest are also evolving. The next generation is more willing to invest through professional managers and other third parties. The latest change in growth trend and economic reforms are prompting individuals to take more risks and switch their savings to other investment products. The emergence of private banks, private equity funds and internet peer-to-peer (P2P) portals is helping to sustain this diversification process.

Arguably, China’s asset management industry offers the biggest opportunity the world’s financial markets have in sight. The same is said for the RMB internationalisation so logically, the two go hand-in-hand. The full convertibility of the currency is on a committed path, which the Chinese leadership has committed to by attaching their reputation to its success: it has to be achieved within their term. The array of new policies and initiatives brought in to foster this cause is dazzling: RQFII, RQDII, Qualified Domestic Limited Partnership (QDLP), two-way sweeping, swap lines with different countries, and of course, the game-changing Shanghai-Hong Kong Stock Connect. The next big thing is the mutual recognition of mutual funds between mainland China and Hong Kong, which will be a major milestone for the asset management industry.

The asset management market is huge, but competition is also fierce. Those who are equipped with both a deep understanding of the Chinese market and international expertise definitely stand a better chance of leading the way. For this reason we should expect to see Chinese managers to be among the world’s biggest and best performers within the next five years.
Annex

About the City of London Corporation

The City of London Corporation is a uniquely diverse organisation. It supports and promotes the City as the world leader in international finance and business services and provides local services and policing for those working in, living in and visiting the Square Mile. It also provides valued services to London and the nation.

One of the City of London Corporation’s main aims is to support and promote ‘the City’ as Europe’s and the world’s leader in international finance and business services. As part of this goal it engages with business, governments, policy makers, legislators, trade bodies, academics and think tanks throughout the world on issues affecting the financial sector in the UK and in other key markets globally.

About the City of London and China

The City of London manages a dedicated programme of engagement with China, facilitated by our representative offices in Beijing and Shanghai.

The City of London’s China programme supports the interests of the UK-based financial sector in China and promotes partnership and two-way exchange in financial and professional services between the UK and China. This work is guided by the City of London Advisory Council for China which was launched in 2010 and provides advice on the City’s engagement with China and the work of its China-based representative offices.

For more information on the City of London and its work on China, please contact china@cityoflondon.gov.uk
Expert perspectives on China’s capital markets

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