OPPORTUNITIES AND CHALLENGES IN THE CHINESE SECURITIES MARKET, THE RQFII PROGRAM

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The RQFII program ("Renminbi Qualified Foreign Institutional Investors"), an initiative to promote the internationalisation of the Chinese currency has been attracting growing attention in all parts of the world. In spite of the complexity in regulation, more and more institutions outside Asia utilise the program and invest their renminbi funds – for example resulting from settlement of trade transactions – in China. In Central and Eastern Europe, Hungary is the only country with direct investment access to China's onshore stock market and interbank bond market. A country quota of RMB 50 billion (EUR 7 billion) received in 2015 created major opportunities for Hungarian institutional investors, but also posed challenges for them.

RENMINBI – ON ITS WAY TOWARDS THE GLOBAL CURRENCY STATUS

The internationalisation of the renminbi is one of the primary objectives of the Chinese economic policy. The first phase of the internationalisation is to promote the use of the RMB in international trade settlements, for example, in foreign trade of goods. The renminbi is now among the major currencies used in international transactions. The second phase of the RMB's internationalisation is to promote the use of the RMB in financial markets through several successive and mutually reinforcing steps. In the initial stage of market opening, the Chinese authorities established the offshore RMB market outside the country, which could serve as a first step on the learning curve. The next stage for moving towards the internationalisation of the Chinese currency was the gradual opening up of the onshore market. In the first round, onshore markets were open to a specific range of Hong Kong financial institutions, and later on to foreign central banks, sovereign wealth funds and supranational institutions. Afterwards, other institutional investors were also granted limited access, for example, through the RQFII program ("Renminbi Qualified Foreign Institutional Investors").

The abbreviation RQFII refers to foreign financial institutional investors that are given access – with their offshore RMB funds to be used – to China's onshore securities market with the approval of the Chinese authorities. Once the RQFII status is obtained, investments in China's stock market and interbank bond market will become available, in both cases in the onshore market. For investors managing portfolios in various currencies, the RQFII program can serve the purpose of diversification. The fact that the Chinese currency has been part of the IMF's SDR basket since October 2016 may encourage the use of renminbi as an investment currency. Demand is expected to grow, driven by the tendency for China to receive credit rating upgrades over the last few years. In 2015, Hungary obtained the RQFII status along with a quota of RMB 50 billion (EUR 7 billion). This paper presents the opportunities opened up to Hungarian institutional investors and the related set of rules. It also analyses the international practice of the RQFII program.

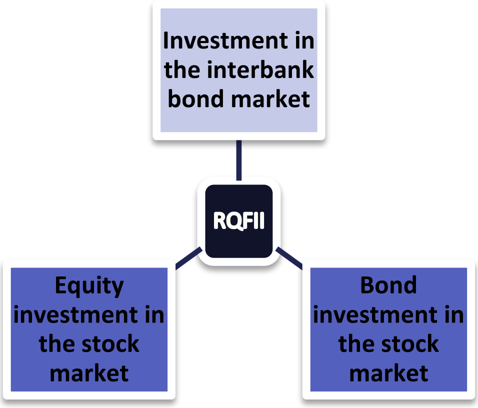
OPPORTUNITIES OF FOREIGN INVESTORS HAVE IMPROVED IN CHINA'S SECURITIES MARKETS

Through the RQFII quota, several instruments are available in China's onshore financial market:

- only equity market investments,
- only bond market investments,
- equity and bond market investments.

Besides equity and bond investments, there are other kinds of instruments available including warrants, stock index futures and other financial products approved by the Chinese regulatory authorities. Usage of the RQFII quota can provide an opportunity for stock investments in the securities market as well as of allocating a portion of an investment fund into onshore RMB assets or setting up an investment fund to invest into onshore RMB assets. There are international examples for ETFs investing in onshore RMB financial assets.

Chart 1: Opportunities available in China's onshore market under the RQFII program



Source: MNB

Requirements imposed by the competent Chinese authorities on foreign financial institutional investors participating in the RQFII program include, among others, the following:

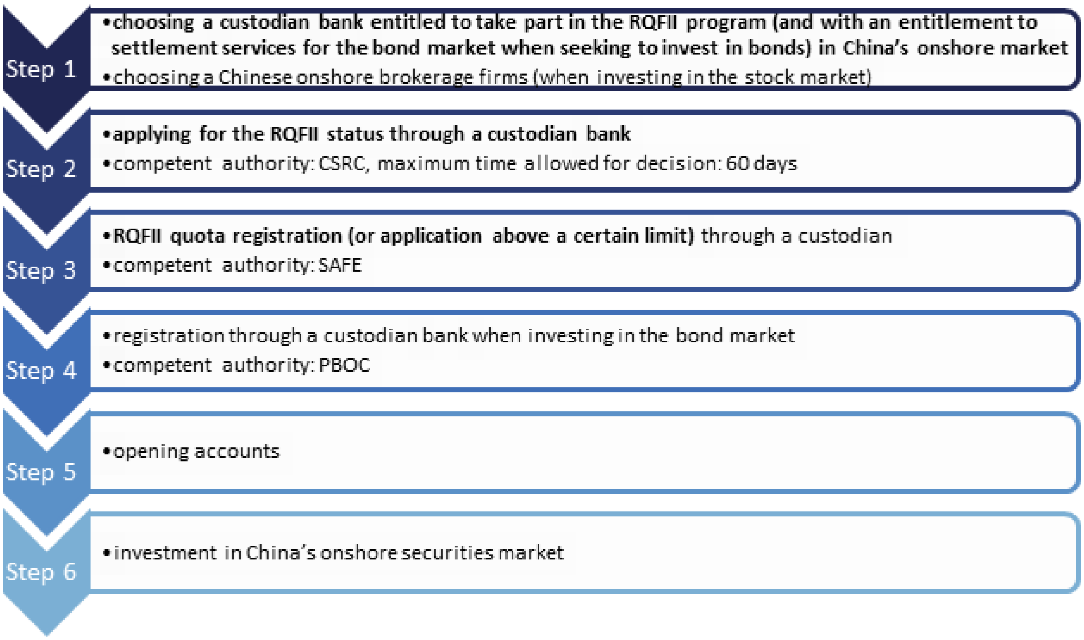
- the institution concerned is registered in its country of residence and operates in accordance with the legislation in force in the country of residence,
- the institution concerned has suitable governance structure and control functions, operates in a robust way,
- in the three years prior to the start of the investment activities in the Chinese onshore market, the competent supervisory authorities did not impose substantial fines for any infringement of the relevant regulations on investment activities,
- the institution concerned has the capability to assess and manage risks.

ENTERING CHINA'S ONSHORE SECURITIES MARKET

Obtaining access to China's onshore financial markets requires the support of a bank qualified as a custodian under the RQFII program. Custodian banks play a key role in the process: they manage the procedures for filing application for the RQFII status and quota in addition to the registration procedures – provided that the investment quota does not exceed a certain ceiling amount. Furthermore, bond trading and settlement are carried out through them and they must report information on the investment activities.

Entering the onshore market is a multi-stage process based on the following steps: First an application for the RQFII status must be submitted to the China Securities Regulatory Commission (CSRC) through the custodian bank. The authority shall evaluate the application within 60 days under the [relevant rules](). Upon obtaining a CSRC licence, an investment quota application can be submitted to the competent authority (SAFE- State Administration of Foreign Exchange) that shall make a decision also within 60 days. An investment plan and a statement on the source of the RMB funds the applicant wishes to invest must be included with the quota application submitted to the authority. If the desired investment quota is below a certain ceiling amount, it is enough for the applicant to be registered with the competent authority. Upon obtaining the necessary licences, accounts laid down by Chinese regulators for onshore investments are set up.

Chart 2: Process for entering the market through the RQFII program



Source: edited from www.chinabond.cn, www.csrc.gov.cn, www.pbc.gov.cn and www.safe.gov.cn

INVESTMENT ACTIVITIES ARE REGULATED

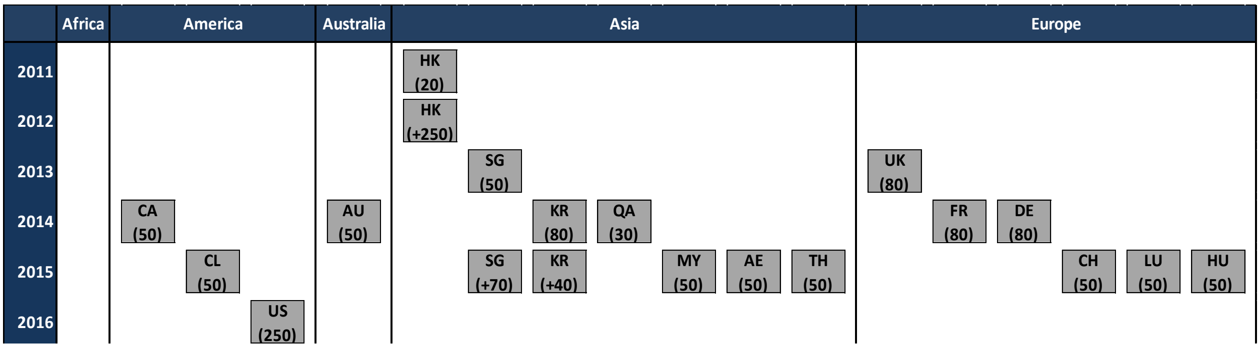
In the exercise of investment and investment-related activities, consideration must be given to the relevant Chinese legal provisions – e.g. issues on taxation, rules governing the extent of gaining influence – and changes should be monitored. Actual investment must be started – except open-end funds – within six months of approval of the quota. Unused quotas may be withdrawn by the authority responsible for the approval of the quota – if it concludes that it is appropriate – within one year of the quota being approved.

Investment-related capital flows are subject to specific rules. With the exception of open-end funds, divestiture is not permitted within three months of investing the last instalment of an intended capital investment (lock-up period). Repatriation of invested capital and investment income is permitted; they can be transferred out of China in RMB or any other currency. Outward remittances are subject to further detailed rules. The competent authorities must be informed through a custodian bank of any amounts transferred both in or out of the country. It is worth taking into account that the Chinese central bank – e.g. in relation to investments in the interbank bond market – encourages foreign institutional investors to take a medium to long term approach.

CHINA ON A CAUTIOUS PATH TOWARD OPENING UP TO FOREIGN INVESTORS

China opted for a gradual strategy – as in any other economic policy liberalisation processes – to create the cross-border RMB denominated investment quota system. The RQFII quota system was launched in 2011 with a quota granted to Hong Kong. The choice of Hong Kong can be justified by the facts that it is an administrative region of China enjoying a special status, its official language is Chinese besides English, and it is one of the leading financial centres in Asia and the world with subsidiaries set up by a number of Chinese financial institutions. Thereafter, the opening-up of the country was extended to further Asian countries (South Korea, Singapore) and Europe's leading financial centres (United Kingdom, France, Germany).

Chart 3: RQFII countries and total quota approved (RMB bn)



Note: Renminbi exchange rate certified by Fed (31 December, 2015): USD 1=CNY 6.4778. Source: edited from SAFE data

Economic and economic diplomacy considerations apply when RQFII quotas are awarded. RQFII quotas are granted, inter alia, with the aim of deepening economic relations (which are mostly already significant) with the given country and promoting the internationalisation of the RMB. As long as the RMB-denominated assets take on an increasingly larger role in the case of financial assets, it will facilitate the process of the Chinese currency attaining the global currency status. Foreign investors support the internationalisation of the Chinese currency through investments using renminbi.

The size of country quotas as well as the timing of quota increases are determined by the Chinese authorities under a prudent policy involving carefully designed steps. The initial quota of RMB 20 billion (EUR 2.8 billion) granted to Hong Kong as a pilot exercise was raised to the current amount of RMB 270 billion (EUR 38.2 billion) in two steps within a year. The system functioned in a correct and safe way, which led to quota increases in other Asian countries (Singapore, South Korea), too.

China does not particularly differentiate between countries in terms of the size of the quota granted. Renminbi limits obtained are practically independent of the size of the countryies' economy or financial sector. However, a typical 50 billion RMB quota (EUR 7.1 billion) is naturally quite a different dimension for Hungary or a European financial centre where securities holdings of the financial sector are several times higher than those of Hungary. The aggregate quota granted to Hong Kong is highly significant compared to that of other selected countries. The only quota allocation approaching its value is the quota of the United States (RMB 250 billion, EUR 35.4 billion) announced in June, 2016.

The RQFII program has now developed into a global network that makes the Chinese onshore market partially available from each continent except Africa and it has opened up the possibility of investing an aggregate amount of RMB 1 500 billion (EUR 212.4 billion) assigned to 17 countries.

INTEREST IN CHINA'S ONSHORE MARKET IS LARGEST AMONG FUND MANAGERS

More than one third of the aggregate country quotas have been awarded to institutional investors. The highest demand was observed in Hong Kong where the full amount – increased on two occasions – was allocated by September 2014. Most quota holders in Hong Kong – including the TOP 10 Hong Kong RQFIIs that obtained more than half of the country's total quotas – are subsidiaries of Chinese institutions. These indirect domestic investments make it possible for China to open up its market in a safer way. In the other two Asian countries obtaining quotas in the first stage of the program, the ratio of allocated quotas is also high amounting to 47% in Singapore and 62% in South Korea, calculated as a percentage of the increased quotas. Also, there is a comparatively high allocation rate in Australia where the subsidiary of the American Vanguard, one of the biggest fund managers in the world owns 60% of the country's RMB 50 billion quota (EUR 7.1 billion). It is considered to be a significant value as almost 70% of the individual institutional quotas is less than RMB 10 billion (EUR 1.4 billion). The institution with the largest RMB investment quota (RMB 46 billion, EUR 6.5 billion) is CSOP, a fund manager in Chinese ownership. This institution is actively using its quota. Most of the RQFII EFTs established by it can be traded on the Hong Kong Stock Exchange, and it also manages an RQFII ETF that is listed on the London Stock Exchange.

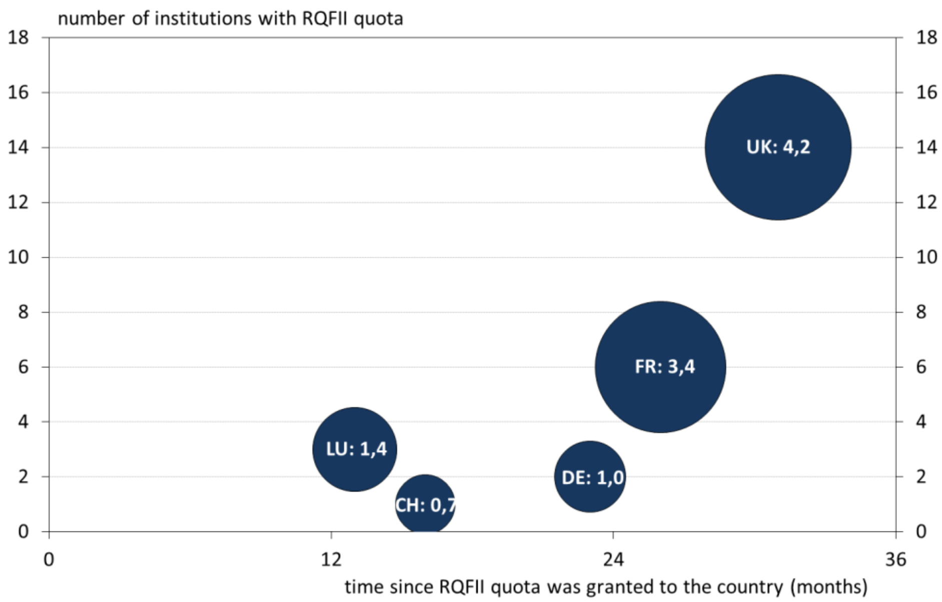
The RQFII regime has attracted different levels of demand from the potential types of institutions. Among the various forms of institutions, investments denominated in renminbi are the most attractive for fund managers as regards the international practices. The number of banks holding RQFII quotas is relatively low, whereas other non-banking institutions (e.g. insurance companies, pension funds) participate very little in the program. Several examples can be found in which a group requested and received quotas in more than one country. BlackRock, for example, the biggest fund manager in the world received quotas in Hong Kong, the United Kingdom and Singapore, of which the quota from Singapore allocated a few months ago stands out as the biggest (RMB 20 billion, EUR 2.8 billion).

MORE AND MORE EUROPEAN INSTITUTIONAL INVESTORS APPLY FOR RQFII QUOTAS

China is opening up to European financial institutional investors as well. The significance of China in Europe is reflected by the fact that more than a quarter of the total quotas issued under the RQFII program have been received by European countries, whereas Asia is the only continent that holds more country quotas. In 2013, the United Kingdom was among the first to get the advanced status. Hungary is the only country in Central and Eastern Europe that has received an RQFII quota.

For the time being, Europe is lagging behind Asia in the allocation of institutional quotas, which can be explained by the fact that the program was extended to the continent at a later stage. It may also be attributable to distance, different time zones, language barriers and informational disadvantages. At the same time, demand in Europe is gradually increasing and the number of institutional quotas allocated is now almost 30 amounting to RMB 75 billion (EUR 10.6 billion). In the United Kingdom, interest in the program is bigger than the European average – independently of the early obtaining of the RQFII status and the effects of the higher value of the country's quota. (see Chart 4). The allocation rate of the UK country quota is 36%. Last year, as a result, China started discussions about increasing the UK quota. There is a similar situation in Luxemburg where one fifth of the country quotas have been used up within a year. However, it should be added, that two out of the three eligible institutions are European subsidiaries of Chinese banks. Luxemburg also functions as an important renminbi hub, which may generate further demand.

Chart 4: Interest for RQFII quotas among institutional investors in Europe (total institutional quotas, EUR bn)



Note: Figure for the number of institutions rejected by Chinese authorities is not available. Source: edited from SAFE (29 June, 2016)

For the time being, experience with the RQFII program in Europe is limited. Most of the biggest institutional quota holders have just received quotas and the value of their quotas is low to their size, accounting for an average of 1% of the assets under management (see Chart 1). Quotas available for European institutional investors receiving the green light from Chinese authorities are similar in terms of volume when compared to those of allocated to Asian countries. On average, a European RQFII – as is the case in other continents – can use an investment quota limit of RMB 3 billion (EUR 0.4 billion). At present, there is a growing interest among European institutional investors, which could lead to further quota requests and investments.

Table 1: Top 5 European RQFIIs

Name	Country	RQFII quota approved for the institution (date)	Value of RQFII quota approved for the institution (EUR mln)	Asset under management (all currency, EUR bn)
Lyxor Asset Management	France	May, 2015	850	94
Carmignac Gestion	France	June, 2015	850	58
Deutsche Asset & Wealth Management	Germany	March, 2015	850	721
Swiss Reinsurance Company	Switzerland	July, 2015	700	-
Generali Investments Europe	Luxembourg	April, 2016	700	372

Note: 2015 year-end value of assets under management. Quota conversion is based on ECB reference exchange rate for Chinese yuan renminbi (published on 31 December, 2015: EUR 1= CNY 7.0608) Source: edited from SAFE, IPE data

To sum up, the RQFII program represents both an opportunity and a challenge for institutional investors. It provides access to a new, sizeable market opening up new investment and diversification opportunities. At the same time, getting to know the market, following the market developments can be a challenge for the eligible institutional investors. Also, the complexity of the relevant regulatory framework coupled with other factors (including different time zones, language barriers) can pose additional challenges. International experience confirms this dualistic tendency. Over the first five years of the program, the interest among international investors has increased steadily; however, the value of total quotas allocated – especially outside Asia – is still relatively low. The fact that the renminbi has been part of the IMF's SDR basket of major currencies since October 2016 can potentially contribute to an expansion in demand in the future.