HOW TO INVEST IN CHINA: NAVIGATING THE MARKET ACCESS SCHEMES

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BNP PARIBAS

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TABLE OF CONTENTS

THE KEY SCHEMES FOR INVESTING INTO CHINA'S STOCK AND BOND MARKETS

In this BNP Paribas guide, we will outline the five main schemes available to investors looking to access China's capital markets as of April 2021, along with their key features and the most significant planned developments.

THE FIVE SCHEMES ARE:

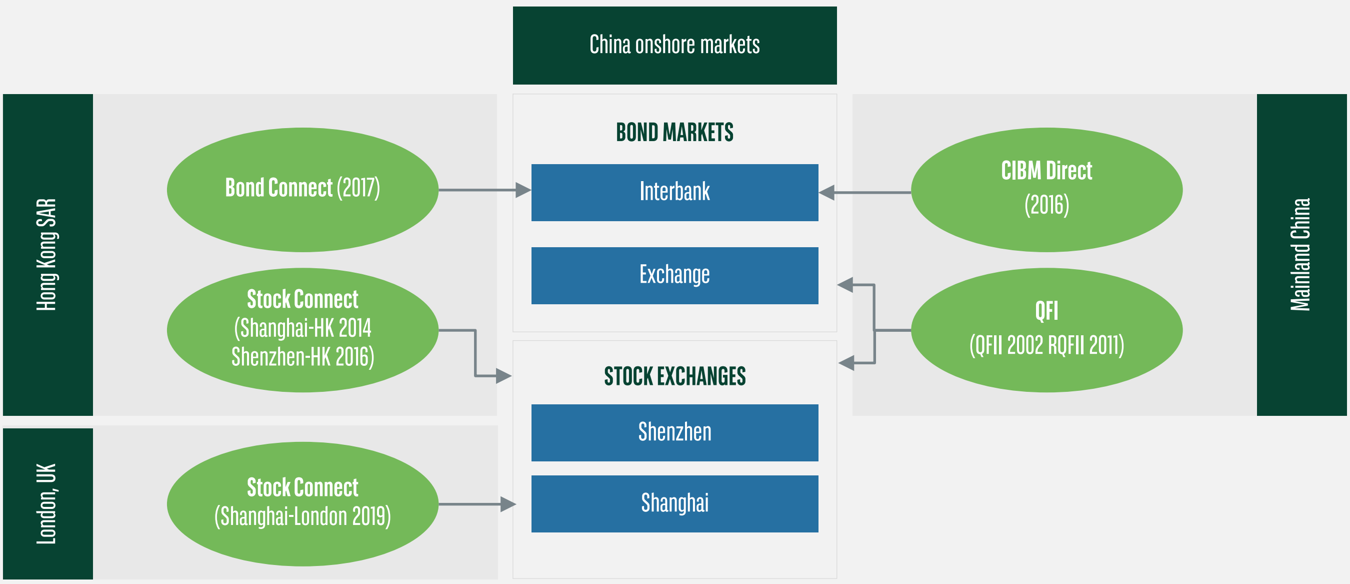
01	02	03	04	05
Qualified Foreign Investor (QFI)	China Interbank Bond Market (CIBM Direct)	Bond Connect	Stock Connect	Shanghai-London Stock Connect

These programmes are not static: each has been refined and expanded since launch and this will likely continue as more participants join and as regulators streamline procedures and broaden their scope.

The schemes can be divided into two onshore and three offshore schemes. The first onshore programme is the **Qualified Foreign Investor (QFI)** scheme, which evolved from the 2020 merger of the QFII scheme (Qualified Foreign Institutional Investor) and the RQFII scheme (RMB Qualified Foreign Institutional Investor). The second is the **China Interbank Bond Market (CIBM Direct)** scheme, which offers direct access to the bond markets.

Two of the offshore schemes are **Stock Connect and Bond Connect.** These mutual market access schemes, which were launched via Hong Kong, give offshore investors licence-free and (at the individual investor level) quota-free access to Chinese assets, while also providing outbound investment channels for Chinese institutions and residents.

The third offshore scheme is the **Shanghai-London Stock Connect**, which offers the possibility for Chinese and UK issuers to list their stocks on each other's stock exchanges. Chinese issuers (there are only four, for the time being) participating in this scheme have their stocks quoted on the London Stock Exchange (LSE); reciprocally, UK issuers have their stocks quoted on the Shanghai Stock Exchange (SSE). Those stocks quote under the form of depository receipts. As such, looking specifically at the eastbound flow, foreign investors can access Chinese stocks through the LSE.



The five key schemes allowing access to China's capital markets: BNP Paribas is live with all of them. Note that the QFI scheme also provides access to markets such as the National Equities Exchange and Quotations (NEEQ), as well as the CFFEX futures exchange and commodities exchanges.

01

THE QUALIFIED FOREIGN INVESTOR (QFI) SCHEME

INFRASTRUCTURE

In 2020, China streamlined the approach that foreign institutional investors (FIIs) had to take to access its capital markets. Before that, FIIs wanting to gain direct access to trade A-shares of Chinese stocks on Chinese stock exchanges had (as of 2002) to be licensed by the China Securities & Regulatory Commission (CSRC) under its Qualified Foreign Institutional Investor (QFII) scheme or, starting in 2011, under its Renminbi Qualified Foreign Institutional Investor (RQFII) scheme.

The two schemes had a number of differences, including quotas, funding currencies and eligibility requirements. Those differences were eliminated when they were merged into the single Qualified Foreign Investor scheme (QFI) in 2020. QFI simplifies and streamlines the process of applying to invest in China's capital markets and opens it up to more foreign applicants.

The QFI scheme is a welcome step forward that means a wider range of foreign investors can access not only China's stock exchanges and bond market, but also stocks listed on the National Equities Exchange and Quotations (NEEQ, "The New Third Board") as well as futures on the China Financial Futures Exchange (CFFEX) and its commodities exchanges.

WHAT'S NOTABLE ABOUT THIS SCHEME?

The revisions to the QFI bring about a number of important changes, including:

- The set-up time should prove quicker than before (subject to document-readiness) and require only a one-time application; the approval time has also been halved to 10 days once the application documentation fulfils the CSRC's requirements
- A number of restrictions have been removed, including complex requirements for each client segment and limits on the number of intermediaries
- Account and capital management rules have been relaxed, the quota has been removed, and the repatriation of profits is much simpler
- The new QFI scheme gives foreign investors much greater scope into China's capital markets (see table)

Table: Scope of investment under QFI

	QFII/RQFII – PREVIOUS SCHEME	QFI NEW REGIME (EFFECTIVE FROM 1st NOVEMBER 2020)
INVESTMENT SCOPE	a. Stock, bonds and warrants traded on the stock exchanges b. Bond products and derivatives products in CIBM approved by the PBOC c. Securities investment funds (mutual funds) d. Index futures on the China Financial Futures Exchange (CFFEX) for hedging purposes e. FX derivatives traded for hedging purposes f. New share issuance, convertible bond issuance, secondary share offering and subscription for allotment g. Other financial instruments permitted by the CSRC	**Extended investment scope in addition to the scope in old scheme:** a. Depository Receipts (DRs) and Asset-Backed Securities (ABS) listed on the stock exchanges b. Financial futures contracts listed and traded on the CFFEX for hedging purposes c. Bond repo on the stock exchanges d. Stocks listed in the National Equities Exchange and Quotations (NEEQ, "The New Third Board") e. Commodities futures listed in eligible commodity futures exchanges approved by the CSRC f. Listed options in exchanges approved by the state council or the CSRC g. Margin financing, securities financing and securities lending h. PFM funds registered with AMAC or founded by a securities or futures institution where the investment scope should be within the QFI investment scope permitted by the CSRC i. New share issuance, bond issuance, ABS issuance, secondary share offering and subscription for allotment on exchanges and NEEQ

An overview of the broader access to China's capital markets now available under the QFI scheme

Another key change is that the QFI has replaced strict criteria related to an applicant's assets under management and number of years of operation with softer requirements, including that:

- They are in sound financial condition and of good credit standing
- Their governance structure is sound
- They comply with relevant rules and haven't been subject to major punishment by regulatory authorities

PLANNED AND POTENTIAL DEVELOPMENTS

The key development revolves around settlement. The current settlement cycle for stocks on the exchange markets is T+0 for securities and T+1 for cash. However, this differs from international delivery versus payment (DvP) standards, and the regulators are looking to implement DvP settlement that is more in line with international standards.

02

CHINA INTERBANK BOND MARKET (CIBM DIRECT)

The China Interbank Bond Market (CIBM) is home to government and policy bank bonds – about 85 percent of bonds traded as of November 2020. (Corporate bonds are traded on stock exchanges or relevant exchange markets.)

INFRASTRUCTURE

From 2010, China's CIBM Direct scheme allowed foreign central banks and others to invest in the CIBM, subject to PBOC approval and quota limits.

It was later expanded to include, for example, foreign financial institutions, sovereign wealth funds and most FIIs. In addition, the approval process of the PBOC has been replaced with a filling process through a bond settlement agent (BSA), and the pre-existing quota limit has been removed.

CIBM Direct allows participants to invest or conduct transactions in the bond market, with different participants granted different investment permissions to access particular products. Investment is required in either CNY (onshore) converted from foreign currencies or CNH (offshore), with repatriation in the same currencies – subject to the currency ratio control imposed by the State Administration of Foreign Exchange (SAFE).

In 2021, the PBOC simplified the filing process for asset managers: previously, filing had to be done at the product/fund level, but this can now be done at the asset manager level. This removes the need for multiple filings that was formerly required when the same asset manager launched different funds.

The CIBM Direct scheme is also more flexible: FIIs can now perform FX spot trading and FX derivatives trading with third-party agents where previously that function was limited to the BSA.

WHAT'S NOTABLE ABOUT THIS SCHEME?

The most notable aspect is that foreign central banks, monetary authorities, sovereign wealth funds and RMB clearing/participating banks can trade bond repo through CIBM Direct. As yet that is not possible through the other inbound investment schemes.

PLANNED AND POTENTIAL DEVELOPMENTS

Investors can expect more improvements in future. First, the regulatory authorities announced in July 2020 that the CIBM and the exchange bond market would be connected, with infrastructure permitting qualified investors to trade on both. However, no further details have since been released.

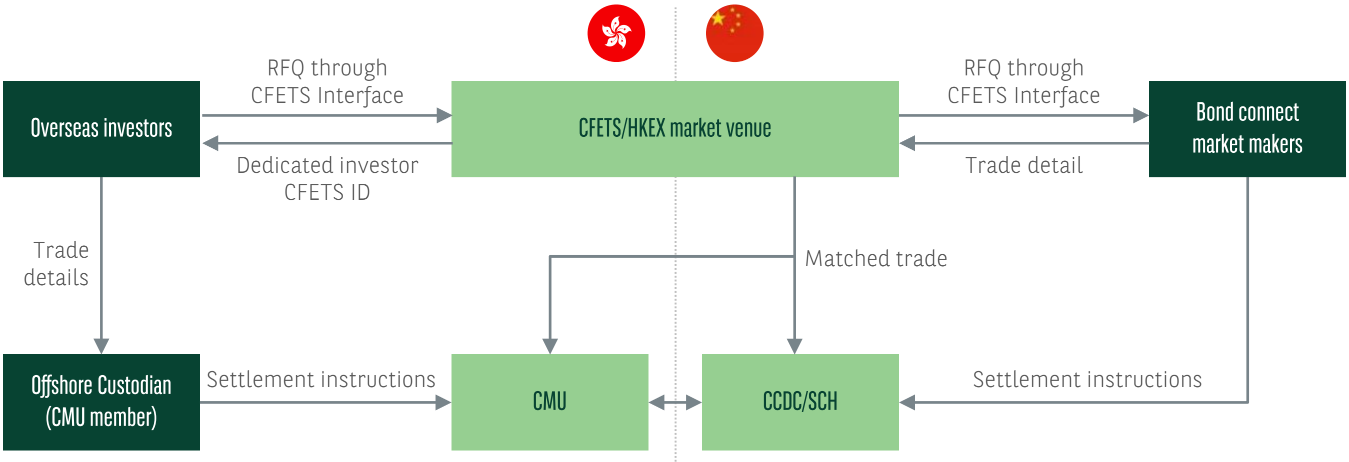
In addition, a range of other changes are expected following the authorities' issuance in September 2020 of the China Bond Market Consultation. These expected changes include:

- Introducing the GC-LC model to be in line with international practice, allowing FIIs to directly entrust a global custodian who will then entrust a local custodian
- Allowing local custodians to open nominee accounts with CSD so that FIIs are not required to open the dedicated account in CSD in their own name. This also follows international practice, and was mentioned again in a more recent PBOC announcement in 2021
- Allowing bond and cash positions to be transferred freely for the same investor with the QFI scheme and the CIBM Direct scheme

03

BOND CONNECT

INFRASTRUCTURE



Source: BNP Paribas

For illustrative purpose only

Clearing and Settlement

- **CFETS** – China Foreign Exchange Trade System
- **HKEx** – Hong Kong Stock Exchange
- **CCDC** – China Central Depository & Clearing
- **SCH** – Shanghai Clearing House
- **CMU** – Central Moneymarkets Unit
- **RFQ** – Request For Quotation

Bond Connect was launched in July 2016, and initially allowed investments into China only. It is designed to complement the CIBM Direct scheme in giving offshore investors access to China's USD$15 trillion bond markets[1].

WHAT'S NOTABLE ABOUT THIS SCHEME?

Similarly to CIBM Direct, only institutional investors are eligible to participate in the Bond Connect scheme. Approval is relatively simple, with a rapid "time-to-launch", and participants enjoy no direct quota limitation and need not submit an investment plan.

Bond Connect allows investors to trade and settle CIBM bonds using offshore infrastructure only, with a dedicated e-trading interface via TradeWeb and Bloomberg.

Funding and hedging are permitted via offshore or onshore RMB, with new rules allowing more options to deal with up to three FX counterparties for onshore RMB. Although FX hedging instruments are permitted, Bond Connect investors currently have no access to repos.

The Bond Connect scheme has seen a number of recent developments, including:

- Flexible settlement cycles of T+4 and above
- Allowing settlement recycling so that failed trades can be rolled over without being re-booked
- Extending trading hours to 8pm for T+1 trades onwards
- Investors may appoint three FX banks for their onshore RMB FX funding and hedging needs
- Introduction of a simplified application process to enable quicker turnaround time for approvals

1. See: https://www.bloomberg.com/news/features/2020-11-22/china-s-bond-market-opening-is-set-to-reshape-the-financial-world

DIRECT CIBM ACCESS

- ✚ Access to both onshore and offshore hedging instruments (FX and Rates)
- ✚ Access to onshore liquidity management tools
- ✚ Onshore set-up adequate for long-term and large investment size strategies
- ✚ Dedicated and tailor-made service provided by local settlement agent and custodian bank
- ▬ Longer set-up process

BOND CONNECT

- ✚ Investors with more dynamic strategies are also accepted
- ✚ Simpler application process and shorter expected turnaround
- ✚ Trading via E-platform and access market makers electronically
- ✚ Can leverage on existing offshore custodian
- ✚ Offshore hedging and access to certain onshore instruments via CMU member
- ▬ No access to onshore repo

PLANNED AND POTENTIAL DEVELOPMENTS

Bond Connect has seen a number of important developments, with more in the pipeline. First, the authorities are reviewing the possible introduction of repos and other derivative products.

Second, the authorities have announced third-party onshore RMB FX rules, which are pending the establishment of operational frameworks by eligible FX banks.

And last, a review is underway to let international investors access the corporate bond market via Bond Connect (as well as via CIBM Direct).

04

STOCK CONNECT

INFRASTRUCTURE

STOCK CONNECT	LAUNCHED IN NOVEMBER 2014		LAUNCHED IN DECEMBER 2016	
	Investments into China	Investments from China	Investments into China	Investments from China
	上海證券交易所 SHANGHAI STOCK EXCHANGE	HKEX 香港交易所	深圳证券交易所 SHENZHEN STOCK EXCHANGE	HKEX 香港交易所
SHARES INCLUDED (AS OF APRIL 1, 2021)	588	362	885	519
DAILY "NET BUY" QUOTA	RMB 52bn (USD 7.9bn)	RMB 42bn (USD 6.4bn)	RMB 52bn (USD 7.9bn)	RMB 42bn (USD 6.4bn)

Source:
Investment into China eligible shared listed: https://www.hkex.com.hk/Mutual-Market/Stock-Connect/Eligible-Stocks/View-All-Eligible-Securities?sc_lang=en

Investment from China eligible shared listed: http://www.sse.com.cn/services/hkexsc/disclo/eligible/ and http://www.szse.cn/szhk/hkbussiness/underlylist/ (in Chinese only)

Daily "Net Buy" Quota: https://www.hkex.com.hk/-/media/HKEX-Market/Mutual-Market/Stock-Connect/Getting-Started/Information-Booklet-and-FAQ/FAQ/FAQ_En.pdf

WHAT'S NOTABLE ABOUT THIS SCHEME?

Shanghai-Hong Kong Stock Connect and Shenzhen-Hong Kong Stock Connect (collectively known as Northbound Stock Connect) are notable for a number of reasons. First, they allow offshore investors to trade Chinese stocks from Hong Kong, and allow funding through CNH (offshore) rather than CNY (onshore).

To do this, investors must open an account with an eligible broker (a China Connect Exchange Participant) on the Hong Kong Stock Exchange (HKEX). This allows them to trade A-shares listed on the Shanghai Stock Exchange (SSE) and the Shenzhen Stock Exchange (SZSE).

(It's worth noting, too, that Shanghai-Hong Kong Stock Connect, Shenzhen-Hong Kong Stock Connect and the more recent Shanghai-London Stock Connect are the only schemes that have an outbound channel capability for onshore investors.)

Offshore investors can have up to 20 brokers and, in common with the onshore markets, sell-trades are subject to pre-trade checking by brokers. Although block trading is not currently permitted under Stock Connect, HKEX's 2020 launch of the Master SPSA service does allow fund managers to bulk-execute across several SPSA accounts.

Additionally, the investment scope under Stock Connect is narrower than that for QFI. It includes:

- All constituent stocks of the SSE 180 Index and SSE 380 Index
- All constituent stocks of SZSE Component Index and SZSE Small/Mid-Cap Innovation Index which have a market capitalisation of not less than RMB6 billion
- All SSE/SZSE-listed A-shares that are not included as constituent stocks of the relevant indices but which have corresponding H shares listed on the HKSE, except for those shares that are not traded in RMB or are under risk alert

Lastly, corporate income tax and VAT on coupons is waived until November 6, 2021.

PLANNED AND POTENTIAL DEVELOPMENTS

There are three developments worth noting. The first is the expected launch in 2022 of Synapse, a smart contracts-based post-trade platform that standardises and streamlines post-trade workflows within the compressed T+0 settlement cycle of Northbound Stock Connect.

The second is the industry push for securities-based lending (SBL) rules to be clarified and further expanded to allow foreign investors to participate in the programme.

The last concerns the use of derivative products – which is necessary given that foreign investors increasingly require access to derivatives to hedge their portfolios.

05

SHANGHAI-LONDON STOCK CONNECT

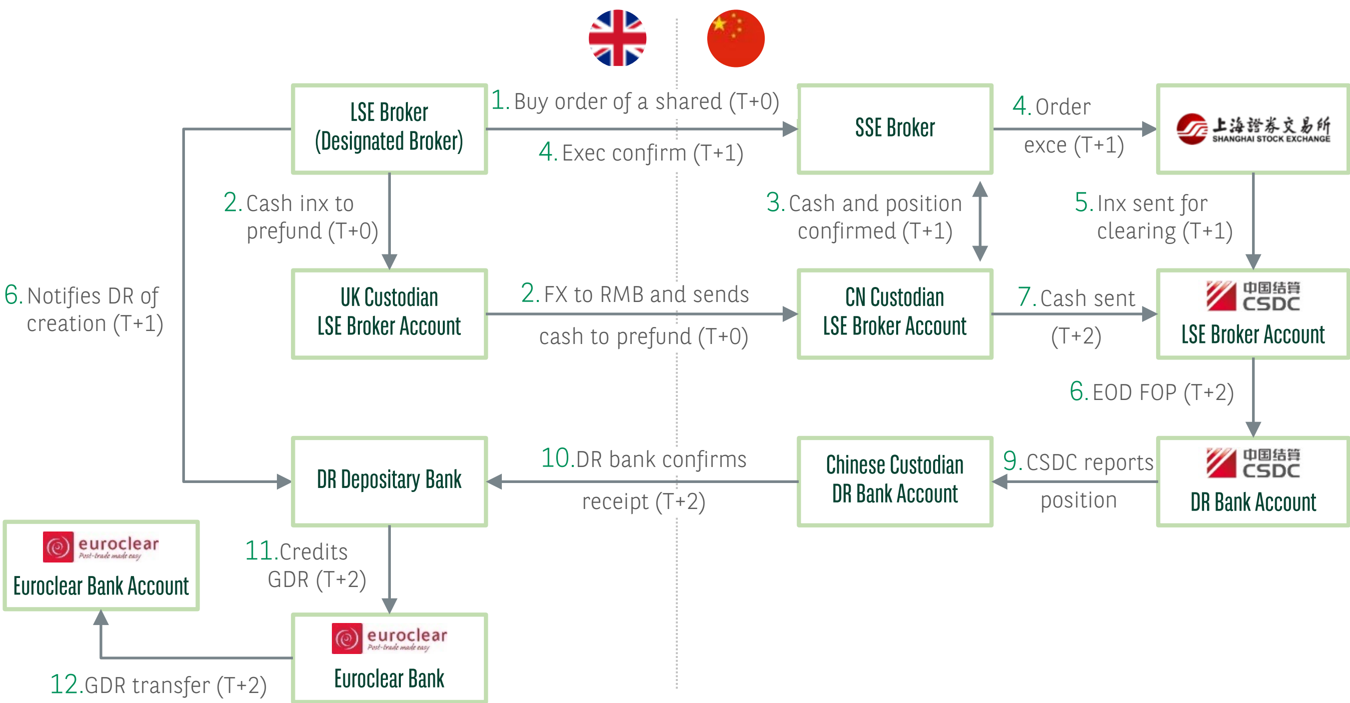
INFRASTRUCTURE

The Shanghai-London Stock Connect was officially launched in June 2019 and offers Chinese and UK brokers and their clients access to each other's markets via a two-way Depositary Receipts (DR) programme.

Chinese Depository Receipts (CDRs) with underlying UK stocks are listed on the Shanghai Stock Exchange (SSE), and Global Depository Receipts (GDRs) with underlying Chinese stocks are listed on the London Stock Exchange (LSE).

"Designated brokers" are entitled to execute trades in the underlying shares in both markets. These brokers arrange the creation and redemption of the DRs through cross-border transactions with a designated Depository Bank. Those designated brokers act as market-makers for the DRs in their domestic market.

GDR creation flows (investment in Chinese A-shares)



WHAT'S NOTABLE ABOUT THIS SCHEME?

Unlike the Shanghai-Hong Kong Stock Connect, the Shanghai-London scheme does not enable direct mutual access to the respective exchanges.

In the Shanghai-London Stock Connect scheme, and looking at eastbound flow, LSE members only have access to those stocks from Chinese issuers that have fulfilled the application process to be listed on the LSE.

This scheme operates under a two-way DR framework where:

- UK issuers already listed on the LSE have the ability to list on the SSE in the form of Chinese Depositary Receipts (CDRs); and
- Large Chinese issuers already listed on the SSE have the ability to list on the LSE using Global Depositary Receipts (GDRs).

"Designated brokers" act as market-makers of the DRs in their domestic market and use their designated counterparts to trade the underlying foreign stocks, facilitating the access and execution of trades through this scheme.

PLANNED AND POTENTIAL DEVELOPMENTS

Currently only four Chinese issuers have completed the process to have their GDRs listed on the LSE, and no UK issuer has applied for listing on the SSE. Additionally, the volume of trades in this scheme has to date been marginal. For foreign investors in China, the Stock Connect schemes via Hong Kong bring more investment opportunities as the range of stocks available is much wider than in the London scheme.

The Stock Connect schemes through Hong Kong are also more efficient for Chinese issuers as they are based on existing listings on the SSE and the SZSE, whereas the Shanghai-London scheme requires that cumbersome administrative applications are completed in order to be listed on the LSE.

BNP PARIBAS FOR YOUR CHINA INVESTMENTS

- Comprehensive China access solutions:
  - QFI, Bond Connect, CIBM Direct, Shanghai and Shenzhen-Hong Kong Stock Connect and Shanghai-London Stock Connect
- Custody capabilities in Mainland China, Hong Kong SAR and the UK
- Hedging solutions and FX capabilities
- Broker to custody solutions
  - Integrated solution for execution and settlement of transactions
  - Clients benefit from a streamlined process

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