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China's Funds Future

China's rapidly growing managed funds sector presents tremendous opportunities for domestic and international investors alike. As the industry changes in response to a variety of macro trends, including a goal of increased domestic consumption, a well-funded pension system and investment overseas, fund managers face a number of challenges accessing this lucrative market. Understanding the evolving fund management landscape will be critical to their future success.

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I. The Funds Opportunity

China has shown considerable dexterity over the past three decades in managing its transition from a small, relatively closed market to a rising economic superpower. It is widely credited with lessening the impact of the global financial crisis, particularly in the Asia-Pacific region, by maintaining its own growth and contributing to international markets with its substantial foreign reserves. The government's continuing reforms have helped speed China's ascent to the second largest economy in the world, after the United States.[1] And the accompanying growth in its financial markets has fueled a rapid rise in the size of China's managed funds sector to more than $335 billion in assets under management.[2]

Nevertheless, Chinese assets remain significantly underweighted in international fund portfolios. Admittedly, much of the reason for this stems from restrictions on foreign access to China's markets. With China's economy on such a growth trajectory, the government's commitment to provide a safety net for its aging population, a growing consumer class and a drive to internationalize the yuan and the economy more broadly, the managed funds sector presents enormous opportunities for domestic and international investors alike going forward.

This Vision Focus report analyzes the macro trends that are likely to affect China's managed funds industry. These trends include government planners' efforts to evolve a less export-driven growth model in an economic environment with a growing middle class and a critical need to create a domestic health and pensions safety net to encourage domestic consumption.

The report also examines current constraints for international fund managers, including foreign investment fund quotas and fund distribution restrictions, as well as the growth opportunities that are emerging for foreign investors. In addition, it looks at the scale of the domestic funds industry and the development of the offshore yuan market as China seeks to internationalize its currency and encourage domestic funds to compete in global markets, including Hong Kong's crucial role.

[1] IMF, World Economic Outlook, April 2011.

[2] Cerulli Associates, Cerulli Quantitative Update: China 2010.

A Growth and Reform Story

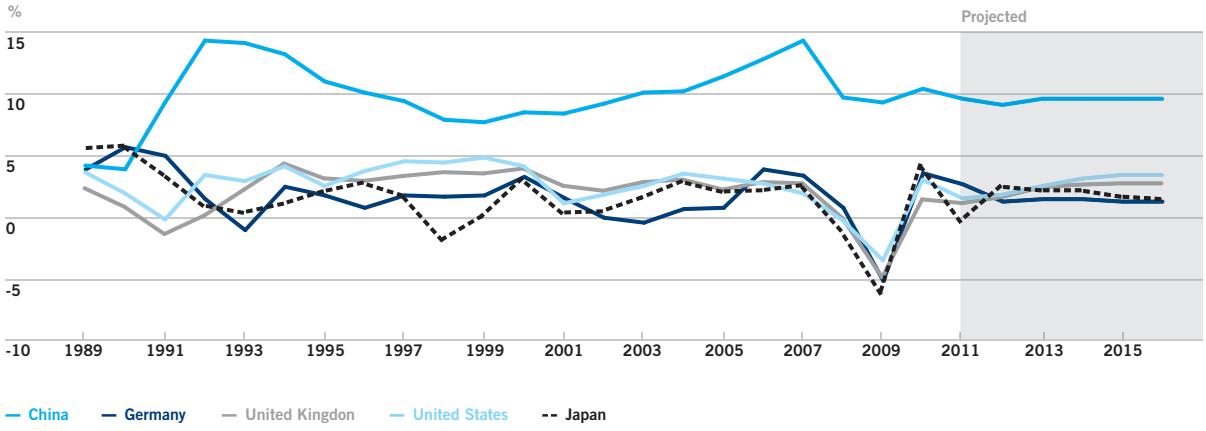
One of the most notable barometers of China's success has been its remarkable GDP growth. Despite regular speculation of a hard landing, China's economy has grown at a consistent and impressive rate since the 1980s. Between 1989 and 2010, for example, real GDP grew by an annual average of 10 percent, outpacing the economies of other major countries such as the US and Germany, whose annual growth averaged 3 percent and 6 percent, respectively, over the same period. And the rapid pace is continuing; China is projected to maintain annual GDP growth of more than 9 percent over the next five years, as shown in Figure 1.

One of the key factors contributing to the growth of China's economy, including its financial services sector, has been the country's increased openness, albeit limited, to international markets over the past decade. As China developed its export manufacturing sector and then began grappling with the inefficiencies of the old state-owned enterprises (SOEs), the country's leadership realized it had to accelerate the process of modernizing its economy, move further upmarket and fully become part of the global economy.

In 2001, China joined the World Trade Organization, a decision motivated by the country's intention to use its membership obligations as domestic leverage to speed up the pace of economic reform and modernization, including in banking and broader financial markets. As part of its WTO obligations, China took steps to begin providing foreign institutions with access to its financial markets through strategic partnerships with foreign institutions, and subsequently listed key Chinese banks on international exchanges.

The reforms — coupled with the soaring growth based on its ever-improving manufacturing and export prowess — have underpinned the development of China's capital markets. This evolution began with the first SOE listings in the 1980s on the Hong Kong Stock Exchange (HKSE) and has continued with subsequent waves of international and domestic Chinese offerings. At the end of 2010, the stock market capitalization of Chinese exchanges surpassed $6.7 trillion, a dramatic rise over the past six years, as shown in Figure 2 on the next page. Importantly, China's equity market has been evolving toward a more even mix of investors and investment classes, with local and foreign investment funds, pension funds, insurance companies, corporations, sovereign wealth funds, Qualified Foreign Institutional Investors (QFIIs) and Qualified Domestic Institutional Investors (QDIIs) playing a more prominent role.[3]

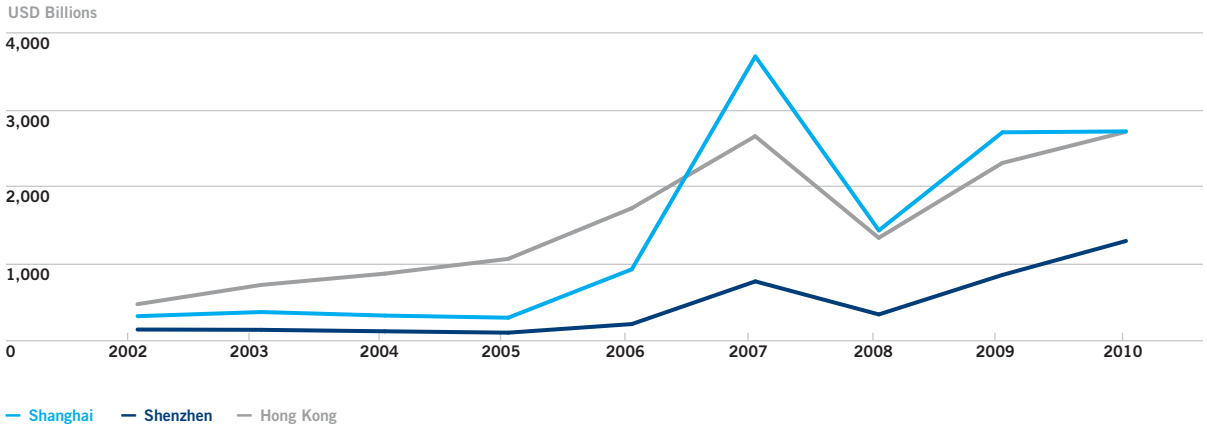
Figure 1: Annual Growth in Real GDP



Source: IMF, World Economic Outlook Database, September 2011

[3] KPMG, "China's Capital Markets — The changing landscape," June 2011.

Figure 2: Domestic Market Capitalization of Shares Traded



Source: World Federation of Exchanges, Annual Statistics, 2011

The scale of the opportunity in the managed funds sector is highlighted by the fact that, although China currently accounts for more than 9 percent of global GDP and over 11 percent of global market capitalization, Chinese assets still only make up 2.3 percent of the MSCI All Country World Index. Moreover, actual investment in Shanghai Stock Exchange A-Shares (available to international investors) comprises less than 1 percent of global portfolios.[4] Importantly, the main reason for the lack of Chinese assets in foreign portfolios has been constraints enforced by the Chinese government, including government-imposed limits on the investment quota made available to foreign institutions.

While foreign participation in the funds sector will continue to face limits in the short to medium term, growth in the managed fund sector in China offers good long-term prospects. The internationalization of China's capital markets is helping to further fuel the rapid rise in the size of its managed funds sector. Over the two-year period from December 2008 to December 2010, foreign fund management companies (FMCs) introduced 174 new funds to the China market, and growth is expected to continue. However, the majority of respondents to a recent PricewaterhouseCoopers survey anticipated some departures from the market by foreign FMCs, and that longer term, new domestic entrants could outpace new foreign players. Despite that, the level of commitment by foreign participants remains resolute.[5]

While limits on foreign participation remain, foreign fund managers need to tap into the opportunities that exist. At the same time, they need to help innovate and internationalize the domestic industry by offering new products and services to help create new opportunities. Helping local funds to reduce expenditure by outsourcing key operations is one area where foreign companies could add value.

Third-party service providers offer domestic funds the opportunity to reduce their capital expenditure by outsourcing key operations, including investment management, fund management, operations, accounting, matching and trade settlement. The key strengths of a quality global third-party provider lie in its ability to facilitate operations, technology and product expertise, coupled with a worldwide presence and commitment.

[4] Z-Ben Advisors, Greater China Asset Management-Sector Forecast, June 2011.

[5] PricewaterhouseCoopers, "Foreign fund management companies in China 2011," August 2011.

II. China: Big Challenges, Big Opportunities

China faces a number of challenges in rebalancing its economic model. The sharp decrease in its traditional source of growth — exports — during the financial crisis led to the layoff of millions of workers. Chinese leaders are trying to reorient the economy to facilitate an increase in domestic consumption in part to reduce the impact of future external economic shocks. China injected a huge amount of funds into the economy via a domestic stimulus package, which helped sustain growth but created ancillary problems. China continues to face tensions with some of its global trading partners as a result of trade and foreign exchange imbalances.

Reorienting Growth

China's asset management industry is evolving during a period of major socioeconomic and political transition. Two of the most significant factors likely to impact the managed funds industry are intertwined: the country's leadership wants to transform its export-led economy to a more domestic-driven model, and it needs to provide increased security and a more equitable distribution of wealth to a population that is aging fast. Building out a social security safety net will support the leadership's desire to increase domestic consumption, thus reducing its dependence on export-led growth.[6]

China's economic reforms continue. Premier Wen Jiabao unveiled the Chinese government's 12th Five-Year Plan (FYP) — the leadership's economic road map for the next five years — at the annual National People's Congress (NPC) and Chinese People's Political Consultative Conference (CPPCC) gathering in Beijing in March 2011.[7] The latest FYP was particularly significant, given the backdrop of recent global economic turmoil and increased awareness of the risk of domestic social instability.

The primary objective of this FYP is to restructure the economy by transforming the country's growth model. Commentators described the FYP as a bold initiative that emphasized the quality rather than the quantity of future growth, with a strong focus on increasing domestic consumption and ensuring that China's growing wealth is more equally distributed across the population.

The FYP pledges to fundamentally restructure the economy through four primary initiatives: lowering economic growth targets (the FYP is aiming for 7 percent annual GDP growth instead of the projected 9 percent); increasing domestic consumption (from its current low of 35.1 percent of GDP to around 40 percent by 2015); implementing energy savings; and establishing environmental protection measures.[8] A key concern remains balancing the need for continued growth, albeit at a less supercharged rate, against the risk of inflationary pressures.

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[6] Ibid.

[7] The NPC is China's legislature, while the CPPCC is a larger advisory body representing a variety of groups across Chinese society.

[8] APCO Worldwide, China's 2011 National People's Congress: Fine-tuning the economy with an eye on social stability, March 2011.

Population Pressures

China aims to hold its population at around the current level of 1.4 billion people. However, the percentage of the population that is aging is increasing fast. The Minister of Human Resources and Social Security, Yin Weimin, acknowledged in March 2011 that this poses "a huge challenge to China's pension system." China currently has approximately 165 million people over the age of 60, accounting for 12.3 percent of the population. China's aging population is expected to increase at a faster rate over the next three decades, with the percentage of people over the age of 60 projected to increase to nearly 30 percent of the total population by 2040. By contrast, in India, the corresponding increase is expected to be from 7.6 percent in 2010 to 15.4 percent in 2040.[9]

The majority of China's people are unlikely to increase their consumption levels as much as they could until they feel assured there is a social security net in place to take care of their health and retirement needs. The government recognizes this. Chinese officials have recently stated their intent to build a pension system that will cover both rural and urban populations, representing a huge potential future growth market for asset managers. Health and insurance systems are also being reformed.

The Rise of the Wealthy Consumer

Some of the biggest opportunities for fund managers will come about as a result of China's increasing personal wealth, which will create an ever-larger pool of potential investors for managed fund products. High-net-worth individuals are seen by FMCs as one of the key market segments.[10] Dismissed as illusory less than a decade ago, China's middle class is now estimated by some to be larger than the entire US population and could reach 800 million in the next 15 years, according to some projections.[11]

The government is particularly keen to channel domestic savings away from volatile and inflationary markets such as property. This desire has considerable potential to create opportunities to introduce new financial products such as managed funds and offer greater scope for both international players seeking additional access to China's managed funds industry and domestic players seeking to internationalize their operations and revamp their product lines.

While there are a number of constraints that need to be relaxed as the market evolves, China's managed funds industry represents significant opportunities for both inbound and outbound fund managers, especially as China continues to push for the internationalization of the yuan, as discussed later in this report.

[9] United Nations, "World Population Prospects: The 2010 Revision," May 2011.

[10] PricewaterhouseCoopers, "Foreign fund management companies in China 2011," August 2011.

[11] Helen Wang, "China's booming consumer market," Forbes.com, August 27, 2010.

III. Accessing China's Managed Funds Market

For inbound international financial institutions, the current opportunities to access China's managed funds market remain relatively limited. The dominant position of China's major banks in the distribution market has also proven a barrier. However, there are indications that the government is beginning to further open the domestic banking market to foreign institutions, which might impact distribution models, and there is an increasing range of international fund products available in China for domestic investors.

QFII

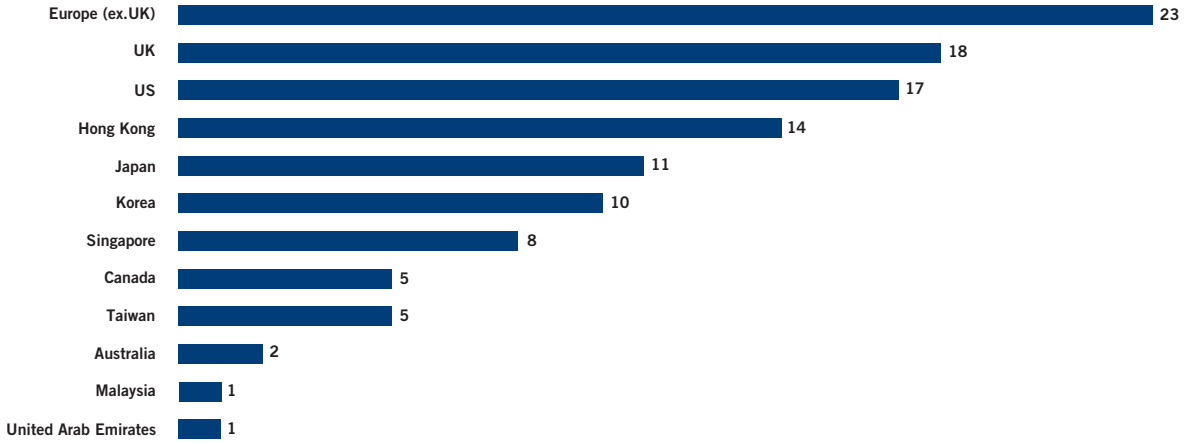
Currently, foreign firms can either participate in the domestic managed funds market through the Qualified Foreign Institutional Investor (QFII) scheme or partner on a minority joint venture basis with a domestic asset management firm. QFII is a scheme for foreign investors, designed to allow a limited inflow of international funds into China while maintaining strict controls over China's currency and the overall flow of funds in and out of the country. Launched by the Chinese government in 2002, QFIIs are only allowed to invest in securities listed on the Shanghai and Shenzhen stock exchanges. The approach is similar to that adopted by other emerging market economies in the early throes of developing their financial markets. Under QFII, international investors need to process an application under the Fund Supervision Department of the China Securities Regulatory Commission (CSRC) to get a license. Separate to this, they then need to apply for a quota to the Reserve Management Bureau, which is part of the State Administration of Foreign Exchange (SAFE). After obtaining the license and quota, the foreign funds can invest in Chinese equities and fixed-income securities listed on the A-share market.

Importantly, there are some key constraints: the total quota under QFII is currently capped at US$30 billion and is approximately two-thirds full as of June 2011.[12] There are also detailed regulations governing repatriation of funds, with a requirement to retain at least US$20 million per QFII account opened at the China Securities Depository & Clearing Corp. (CSDDD) within China to ensure that money flows are kept under control. There's also a three-month to one-year lock-up period before a QFII can repatriate the remitted-in quota and the lock-up period is subject to the type of QFII. In addition, each institution can hold only one QFII license, with the quota linked to a specific product. However, if a different division of the same company wants to access the quota, it can do so — subject to internal agreement on the distribution of the quota — but must apply to SAFE for a separate license linked to the new product. There's also a one-year lock-up period before a QFII can be dissolved. As specified in the scheme's title, the scheme is only available to institutional investors — private investors cannot directly access QFII.

As of July 2011, QFII had attracted applications from 115 financial companies from around the globe, as shown in Figure 3 on the next page. The first round of applicants were investment banks, while the second was composed of a mix of asset management firms and pension and sovereign wealth funds. By the middle of 2011, quotas issued under QFII had

[12] Sophie Baker, *FinancialNews*, "Investors in China Urged to Act," September 20, 2011.

Figure 3: QFII License Holders by Location of Registration



Source: China Securities Regulatory Commission, as of July 2011

reached approximately US$20 billion. Many applicants remain in the queue. The quota will probably be expanded to allow more firms to participate but not by any significant amount. Any additional quota application will also take time.

Mini-QFII/RQFII

The latest expansion of the QFII scheme — and one directly linked to China's desire to expand the use of the yuan outside its borders — is the "Mini-QFII" proposal, known as the renminbi (RMB) qualified foreign institutional investors (RQFII). A CSRC official confirmed in August 2011 that rules had been drawn up for a trial program that will allow domestic Chinese brokerages and fund companies to raise money offshore for investment in the domestic financial market. Chinese institutions based in Hong Kong are not able to participate in the standard QFII program.[13]

The approved investors would be allowed to invest in mainland securities markets with an initial size of 20 billion yuan (US$3.1 billion). The applicants were understood to include 20 mainland securities dealers, nine mainland fund managers and nine mainland fund companies' Hong Kong branches. However, while CSRC is understood to be discussing the scheme with its Hong Kong counterparts, the mainland banks' brokerage units, Hong Kong securities dealers and foreign securities dealers might not be included in the first group approved for the RQFII scheme.[14]

RQFII will allow Chinese fund managers to compete directly with major international financial institutions for funds. Reports suggest that at least 80 percent of the money raised will have to be invested in China's domestic bond market.[15] RQFII will have a separate quota from those for QFII and QDII. The initial quota cap of 20 billion yuan (US$3.1 billion) is significantly less than the traditional QFII program of US$30 billion but will probably grow quickly.

Making Do With a Minority

The main route to participation in China's managed funds industry is by entering into a joint venture with a domestic financial institution. So far, the CSRC has approved the establishment of 37 Sino-foreign equity joint venture fund management companies.[16] But foreign asset managers continue to have concerns

[13] Leigh Powell, *AsianInvestor*, citing Z-Ben Advisors data, "China bond, QDII funds put equity products in the shade," January 5, 2011.

[14] *China Securities Journal*, "China's RQFII rules expected next month," August 30, 2011.

[15] Xinhuanet, "RQFII enhances HK's role as offshore RMB center, boosts yuan's internationalisation," September 13, 2011.

[16] Sarah Mishkim, "China proving tough for foreigners, " FT.com, September 4, 2011.

about the requirement to accept a 49 percent minority stake in the joint ventures, as well as other limits on the types of business that can be conducted. Foreign asset managers argue that greater flexibility from the regulators and more control by foreign investors are needed to make the joint venture model work effectively and further develop China's managed funds sector. A wholly owned foreign venture is the favored model for many.

Nonetheless, the market continues to evolve. For example, the Shanghai Municipal Government launched the Qualified Foreign Limited Partner (QFLP) program in 2011, a pilot scheme that allows qualified foreign institutions to convert foreign currencies to yuan to make private equity investments in China. However, the pilot scheme excludes foreign private equity firms from some business sectors, such as the A-share market, derivatives and commercial real estate.[16] Another change is the development of some synthetic products by international firms using borrowed A-shares to create new products such as exchange traded funds (ETFs) on external markets via structured note issues. Domestic brokers acquire the A-shares on behalf of foreign firms without a QFII quota. Because the domestic brokers are using their own capital, the subscription and redemption of such shares does not impact the amount they can commit in the Chinese market. The ability to borrow shares for such products allows foreign fund managers to do some short-term asset allocation, but comes at the cost of the broker's fee. So far, the regulatory authorities have been neutral in their response to this approach.

The Distribution Dilemma

To date, the key distribution channel — and distribution constraint — for asset management products has been China's domestic banking system. Bank outlets, dominated by the top four state-controlled banks, control distribution access across the nation and about 60 percent of mutual funds are distributed by bank outlets with a high churn rate.

China's banking sector has undergone a major overhaul, but there is more to do. A decade-long restructuring, including the bailout of bank non-performing loans and recapitalization in the 1990s, cost the government an estimated US$650 billion. That was followed by the transformation of the banks from an SOE to a shareholder model through a succession of international IPOs over the past decade. The most recent listing saw Agricultural Bank of China, the last major lender to go public, which raised US$22.1 billion on the Shanghai and Hong Kong stock exchanges in one of the world's biggest equity offerings. However, despite the public shareholdings, government control over China's banks remains tight.

Independent fund managers are not in a position to reach out to the mass of retail investors with new products in the same way that major Chinese banks can, with their national branch networks and massive retail customer bases. And although product offerings have broadened in recent years, there has been little appetite or incentive for product innovation on the part of Chinese banks. The Chinese institutions' dominance means revenue for fund products distributed through the banks' channels must be shared with the banks. Several companies with less well-known brands are paying fees in the 70 percent to 75 percent range to access distribution.[17] Some mutual fund managers have preferred to focus on institutional business where, though fees may be lower, they are at least not shared with banks. Reaching out beyond Tier 1 cities is seen by market participants as one of the key potential growth sectors, but brand building in a market as huge as China's is challenging in terms of the promotional spending required, notwithstanding the distribution constraints.

Although the Chinese banks' dominance seems unlikely to lessen any time soon, recent changes could have a significant impact on the distribution market over the longer term. The CSRC announced in June 2011 that beginning on October 31, 2011, it would allow independent fund advisors to distribute funds in China. A wide range of financial services organizations, including wealth management advisors, investment agencies, market data producers and funds of funds are reported

[16] Li Yuchuan, "Shanghai allows foreigners to participate in China PE investment," *China Securities Journal*, January 12, 2011.

[17] PricewaterhouseCoopers, "Foreign fund management companies in China 2011," August 2011.

to be preparing to enter the market. The proposed revised regulations will also allow individuals with professional qualifications to set up individual financial advisors (IFAs), and the minimum staff numbers required will be cut from 30 to 10.

The barrier for entry, however, has been set high with a minimum required capital of US$3.1 million.[18] This requirement indicates that Chinese authorities want institutions and individuals with sound financial strength and risk-bearing capacity to enter the market. A large number of IFAs are expected to enter the fund distribution market, which could motivate fund management companies to pay more attention to customer satisfaction and product innovation.

And while local banks remain favored, locally incorporated foreign banks (currently around 40) are increasingly able to offer a larger range of products and services. The IFA announcement confirmed that foreign banks will be allowed to distribute funds on a fee basis. High-net-worth individuals are also the focus of many foreign banks. This might augur well for fund distribution in the short to medium term given the purchasing power of high-net-worth individuals relative to others in the banking system. Overall, these developments are likely to improve access to the Chinese retail market.

Accessing Domestic Funds Going Overseas

Foreign companies will be able to access Chinese funds going overseas via the Qualified Domestic Institutional Investor (QDII) scheme — a complement to the QFII scheme described earlier.

Launched in 2006, QDII allows domestic institutions with locally raised funds to have limited investment access to offshore market assets such as securities and bonds. According to SAFE, US$63.81 billion of quota has been allocated under QDII. Investors are allowed to invest up to 50 percent of their net assets into foreign securities in a range of foreign markets including the developed markets of Hong Kong, the US, Europe and Australia — as long as no more than 5 percent is invested in any one security.

When it was launched, the China Banking Regulatory Commission described QDII investing as an overseas wealth management business. QDII's investment scope has expanded since its launch, and now allows Chinese companies and individuals to invest in foreign financial markets through domestic commercial Chinese banks. Securities firms and insurance companies are also able to participate in QDII.

Despite losses during the financial crisis, the government has continued to expand the program for domestic institutions and individuals realizing the long-term value of diversifying investments overseas. As of December 2010, 88 institutions had been approved as QDIIs. On average, QDII funds and fixed-income products comfortably outperformed both index and equity funds in China in 2010, which might lead to further interest from Chinese investors in this sector.[19]

Future Developments

Investment choices for the Chinese managed funds sector have expanded significantly. Although there are still constraints within the Chinese market, the range of allowable investments within the sector has expanded. The CSRC lifted the ban on margin trading and short selling of stocks in April 2010 for a limited number of securities firms and stocks. In August 2011, the CSRC issued a draft for margin trading rules and further loosened its grip by granting permission for exchange traded funds (ETFs) to be traded on margin. These developments are expected to improve efficiencies in fund operations for local markets. However, while introducing counterparty standards will mitigate risks for the margin trading market as a whole and are expected to enhance the profitability of the securities industry in the long-run, with the final legal framework still incomplete and many securities finance companies yet to be established, the business is unlikely to take off until at least early 2012.[20]

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[18] Leanne Wang, *AsianInvestor*, "Industry welcomes move to open China fund distribution," June, 27, 2011.

[19] Leigh Powell, *AsianInvestor*, citing Z-Ben Advisors data, "China bond, QDII funds put equity products in the shade," January 5, 2011.

[20] *Asia Asset Management*, "CSRC issues guidelines on margin trading," August 26, 2011.

As noted above, under the QDII scheme, international products, including US and European fixed income products, and some derivative products, are accessible to local yuan investors. In addition, in early 2011, the CSRC announced a proposal to create a channel for passive equity index products. The new channel would be separate to existing channels for equity funds, fixed income funds, QDII funds and segregated account funds, and seems likely to encourage the development of the ETF market.

Global Yuan Ambitions

As noted, China's long-term goal is to create a role for the yuan as a global reserve currency. Now that Hong Kong has become established as an offshore yuan center, there is added pressure to find new ways to expand the use of the currency, short of full convertibility. The RQFII scheme will allow foreign investors to invest directly in China's domestic financial markets. In doing so, it could also help to raise the attractiveness of the currency to Hong Kong-based investors. Many have argued that a mechanism needs to be found to allow the flow of offshore RMB back into China. If the scheme takes off, domestic funds, as well as overseas investors who currently have yuan deposits sitting in banks outside China collecting low interest rates, are likely to benefit.

To date, only 13 of China's 60-plus fund houses have established overseas operations — all of them in Hong Kong. The Chinese government wants fund houses to gain experience in Hong Kong before going global. With China's clout on the rise following the financial crisis, Chinese fund managers are more optimistic about their ability to compete directly in global markets. For example, third-ranked Chinese fund manager E. Fund Management became the first Chinese house to set up a global emerging markets fund in early 2011, while China Southern Fund Management Co. launched an offshore yuan bond fund that it hopes will outperform international rivals. Within the Greater China asset class, Chinese fund managers could grow market share from 3 percent to 5 percent now to 35 percent to 40 percent by 2020.[21]

Some observers are skeptical, however, that Chinese fund houses will be able to offer significantly lower portfolio management costs. Outside of Japan, there are few large Asian houses that could compete internationally. Asian asset managers have no overseas distribution channels at the moment, and some observers doubt whether European and US distributors would want to handle lower-cost products. However, China Asset Management Co., China's largest fund, has already secured a distribution deal with Commerzbank in Europe, and other major Chinese funds are likely to follow. Whether they can fully expand globally remains to be seen.

[21] Estimate of Z-Ben Advisors, "China funds knock on foreign doors in search of growth," Reuters, June 3, 2011.

Hong Kong has developed a unique role for itself as China's offshore RMB center as China takes steps toward liberalizing and internationalizing the yuan. China sees Hong Kong, the country's Special Administrative Region since 1997, as a good testing ground for yuan programs. The appeal lies in Hong Kong's experience as an international financial center and China's ability to control the risk of negative flow-on effects on the mainland. Hong Kong is equally keen to develop its yuan business.

Hong Kong is also becoming a base or a first step for Chinese fund management companies looking to go global. Since the CSRC's 2008 promulgation of regulations allowing Chinese fund management companies to be established in Hong Kong, 13 have been created. Initially focused on providing advisory management services to their mainland parents, they are increasingly looking to leverage their ability to access Chinese assets and investment opportunities for inbound and outbound Chinese capital flows.

Banks in Hong Kong offer a range of offshore RMB retail banking services such as deposit-taking, currency exchange, remittance, debit and credit cards, cheques, and the subscription and trading of yuan bonds, as well as yuan trade settlement. The foundation is being laid for offshore RMB equities and FDI and ODI programs.

Yuan deposits grew substantially from 2010 following the introduction of Yuan trade settlement and the opening up of China's interbank bond market to some overseas participants and yuan corporate bond issues. As of June 30, 2011, yuan deposits in Hong Kong stood at 553.6 billion (US$87 billion), a 57 percent increase from year-end 2010.[22] Cross-border yuan trade settlement handled in Hong Kong reached 370 billion yuan (US$56 billion) by January 2011, up 516 percent from 60 billion yuan (US$9 billion) at the end of 2009.[23]

Hong Kong's government and business leaders also hope the SAR will be a key player in the development of the Mini RQFII program to funnel offshore yuan back into China. Many believe the funneling of RMB into China is key to the program's success. The mainland government is less keen, seeing the export of the yuan to overseas markets as central to its management of inflationary pressures in China and its long-term goal of internationalizing its currency.

Offshore RMB Infrastructure Needs Development

While there is great interest in the offshore yuan market, much needs to be done. A trading and settlement infrastructure needs to be firmly established. Work is progressing on this via the Hong Kong Stock Exchange and the Hong Kong Monetary Authority. The lack of liquidity is also seen as a major problem. Hong Kong reached its preapproved yuan limit in 2010, and needed to call on bilateral swap arrangements with the mainland to meet demand. Hong Kong is pushing China to raise the amount of yuan available to Hong Kong, but mainland authorities would like to move cautiously. Case-by-case approvals are also needed for various aspects of the program.

Shanghai and Hong Kong

The future roles of Shanghai and Hong Kong have been subject to a long-running debate. Shanghai continues to develop its financial sector at a rapid pace, and some believe that will eventually come at the expense of Hong Kong's standing as the region's business and financial hub. In 2009, a Chinese government agency declared Shanghai would be a financial and transportation center by 2020 — two key industries for Hong Kong — which many saw as an endorsement of Shanghai over Hong Kong. However, governments on both side were keen to stress that there is room for both centers. The general consensus seems to be that Hong Kong will be an international financial center and an offshore yuan center in the short term at least, while Shanghai will be an onshore yuan center and domestic financial center.

[22] Hong Kong Monetary Authority, "Half-Yearly Monetary and Financial Stability Report," September 2011.

[23] Hong Kong Monetary Authority, Briefing to the Legislative Panel on Financial Affairs, March 1, 2011.

IV. Looking Ahead: Challenges and Best Practices for Fund Managers

China's leadership is clearly committed to ensuring that Chinese markets continue to develop to secure the country's role as a global financial player, as reflected in the recently announced CSRC decision to simplify fund approvals. But despite the evolution of regulators' attitudes, both domestic and international fund managers face a number of challenges in further developing the market.

Domestic Challenges

Fund managers continue to face a lengthy and sometimes policy-driven regulatory approvals process that slows the flow of new and more innovative products being brought to market. In addition, the dominance of China's retail bank networks reduce the effectiveness of fund marketing and sales efforts. The authorities' deregulatory moves in the distribution sector are being seen by fund managers as a welcome development that could ease overcrowded bank channels.

The banks' dominance of distribution also imposes high revenue-sharing costs on domestic fund managers who are facing increased hiring costs and relatively depressed capital markets. In addition, the shorter product life cycles, compared to developed markets, and the focus on new product launches, imposes pressures on back-office operations and risk management. Another key issue for foreign and domestic fund managers has been human resources. Finding and retaining good personnel was considered by FMC respondents to the aforemtioned August 2011 PricewaterhouseCoopers survey to be the most difficult problem they faced.

A Role for International Expertise

There is no doubt that some international fund managers have been struggling in China and have lowered their original growth expectations. The recent spate of regulatory changes has been encouraging, but a recent survey of foreign managers indicates that frustrations remain.[24] As noted, entering China's funds market continues to pose considerable challenges for foreign fund managers. Industry observers emphasize that China remains a long-term strategic play, and that a short-term approach is unlikely to be effective. The QFII application process can be expected to take at least a year. With lockup provisions and limits on repatriation of funds, those considering setting up on the mainland need to be planning for a five-to-10-year commitment of capital and resources.

Changes to JV requirements for asset managers seem unlikely anytime soon. The bar for entry has been set high to ensure that foreign participants are of good quality, minimizing long-term risk factors for China, but limiting foreign access.

At a pragmatic level, those wishing to enter the market need to be aware that dealing with regulators requires a lot of patience and that the process is not as transparent as in more developed markets. As with other businesses active in China, managed funds could benefit from being aware of and aligning with the government's priorities and should work to identify Chinese partners whose goals are strategically aligned. Companies should stay alert to changes such as those recently announced on distribution.

[24] Sarah Mishkim, "China proving tough for foreigners," FT.com, September 4, 2011.

Chinese funds could benefit from the best practices in developed markets and the services of third-party providers. For example, outsourcing middle- and back-office operations would free up domestic asset managers to focus on their core competencies, improve profitability and support faster product launches and international expansion. Thus, third-party providers represent a key ingredient in raising the quality of China's domestic asset management operations, increasing product range and facilitating the domestic industry's outbound goals.

China's financial system has changed dramatically in the more than 30 years of reform and opening up. Banks have been privatized, foreign companies are able to participate in the domestic market and Chinese funds are being invested overseas. Assets under management are also substantial and are expected to grow significantly along with China's economy. But accessing Chinese funds can still be difficult for foreign companies. QFII and Joint Venture rules limit investment in the domestic market. QDII rules limit outward investment. Improved access is, however, likely. The government is increasingly willing to accept greater competition in its markets and supports the diversification of investments overseas. Both of these developments bode well for foreign companies. The government also plans to promote domestic consumption and establish well-funded pension, health and insurance systems, which should lead to growth in the investment management industry. Foreign companies should follow developments in China closely and look for opportunities that emerge from the rapidly changing regulatory environment.

Contact Information

If you have questions regarding State Street's services, please contact:

Fangfang Chen
+86 10 6627 1906
fchen2@statestreet.com

Ting Li
+852 2103 0263
ting_li@ssga.com

Sau Kwan
+86 10 6627 1908
shkwan@statestreet.com

Catherine Simmons
+852 2230 1577
cjsimmons@statestreet.com

For questions or comments about our Vision series,
e-mail us at **vision@statestreet.com**.

STATE STREET.

State Street Corporation
State Street Financial Center
One Lincoln Street
Boston, Massachusetts 02111–2900
+1 617 786 3000
www.statestreet.com
NYSE ticker symbol: STT

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