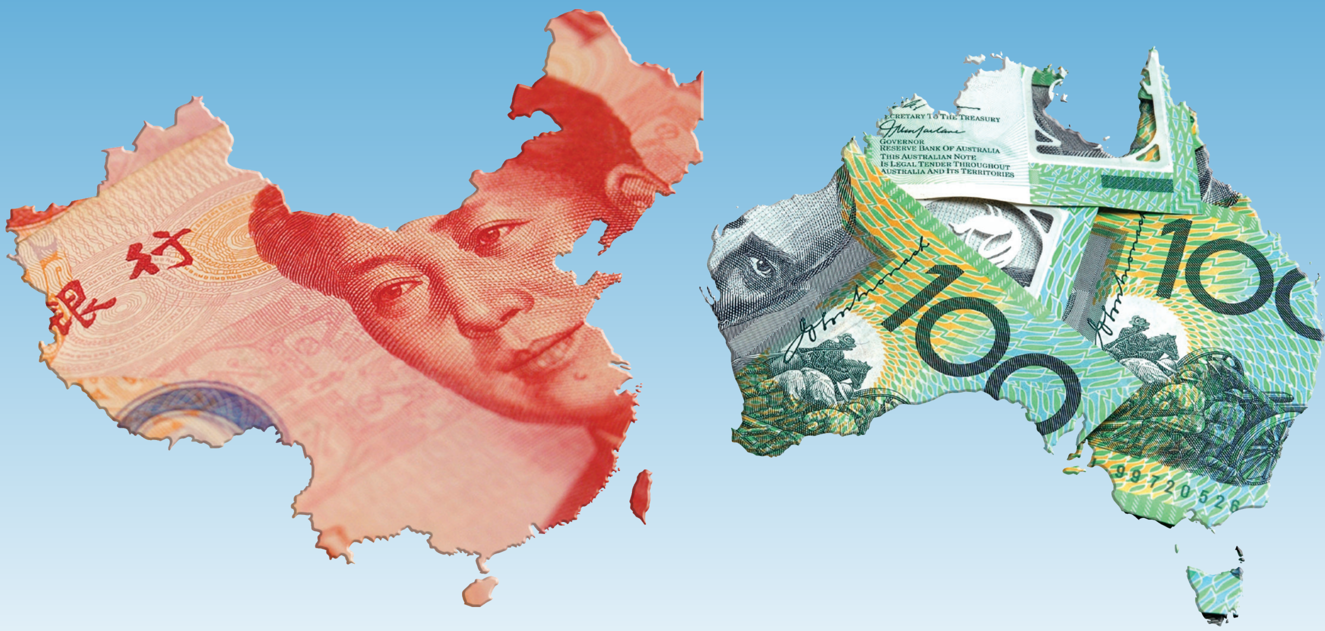
Renminbi Internationalisation and the Evolution of Offshore RMB Centres:

OPPORTUNITIES FOR SYDNEY

Research Report • November 2015



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During 2013 and the early part of 2014, Geoff was a Research Fellow at the Centre for International Finance and Regulation in Sydney, during which time he managed and co-authored a research project on China entitled "Internationalisation of the Renminbi: Pathways, Implications and Opportunities."

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This report is available from **http://www.cbe.anu.edu.au/research/rmb**

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FOREWORD

November 2015

This timely research report comes on the back of Sydney's appointment in late 2014 as an official offshore RMB centre. It identifies the strategies and success factors in offshore RMB centres around the world, and discusses how China's internationalisation of its currency may impact on these centres. It then applies these insights to issues of particular relevance to Australia.

The report builds on a previous one by the authors, "Internationalisation of the Renmimbi: Pathways, Implications and Opportunities", which was published in 2014 by the Centre for International Finance and Regulation. The earlier report explained how reforms associated with internationalisation of the renminbi would, over time, see China's financial relations with the rest of the world match its trade relations, and outlined the profound implications of these prospective changes for global financial markets. It suggested there would be winners and losers as renminbi internationalisation impacted on the type, volume and location of financial market activity around the globe.

There are now some 18 offshore renminbi centres competing for this business. The report looks at what Australia can learn from developments in other offshore centres. It also discusses structural complementarities between the two economies that provide a strong foundation for building closer financial relations with China, and identifies areas where we have specific comparative advantages. Some more technical market issues, such as whether we need to build up local RMB liquidity in order to be a successful RMB hub, are also dealt with.

In addition to Sydney being appointed as an official offshore RMB centre, Australia and China have recently negotiated the China-Australia Free Trade Agreement, which should enhance mutual opportunities across a wide range of industries including financial services. If Australia is to make the most of these developments, the report suggests that market forces need to be supported by structures that enable the financial sector and the official sector to work together more effectively to identify policy constraints that need addressing. These may be domestic policy constraints or market access issues for future negotiation with China. This is an important recommendation which I strongly endorse.

The Chinese Government remains committed to financial market reform and liberalisation. The broad course is clear. The tide of renminbi internationalisation continues to advance. This report is about what we need to do to benefit from it.

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EXECUTIVE SUMMARY

By facilitating use of renminbi outside of China and providing a connection between the onshore and offshore markets, offshore RMB centres play a crucial role in China's gradual move towards internationalising its currency. This research report:

- looks at developments in offshore RMB centres, how the pathway to RMB internationalisation may impact on them and what role they may play once the RMB has been fully internationalised;
- outlines some of the key implications and opportunities for leveraging off the establishment of Sydney as an RMB centre and building closer financial relations between Australia and China; and
- examines the major constraints, both market and policy related, to Australian financial services companies taking full advantage of the opportunities that are available.

The key findings of the report are based on meetings held with both official and market sector contacts during a trip to nine offshore RMB centres; and broader discussions with a wide range of financial services companies across the banking, funds management and capital markets sectors.

Part One: Some Lessons From Other Offshore RMB Centres

- The number of offshore financial centres with official RMB clearing banks has grown rapidly in recent years and now numbers 18. Competition between offshore RMB centres is growing, particularly in geographic areas where there are a number of centres with overlapping models for attracting RMB business.
- For some of these centres, in particular Hong Kong and Singapore, the economic case for being an offshore RMB centre is straightforward and centres around factors such as large local Chinese populations; significant Chinese corporate presence; and trade ties, including roles as regional trading hubs. Other centres, such as Luxembourg and London, have effectively carved out niches for themselves: Luxembourg in funds management and RMB capital market activity, and London, being the largest global foreign exchange centre, in offshore RMB foreign exchange business.
- Going forward, as China continues to open up its capital markets and as the new Cross-Border Interbank Payments System is rolled out and links offshore banks directly with banks in mainland China, the importance of having an official clearing bank, an RMB swap facility and an RQFII quota for investing in China's capital markets will diminish. As with other currencies, offshore RMB activity will gravitate to those centres where the liquidity is and to centres that have effectively found areas of activity in which to specialise.

- However, it is likely to take 5-10 years before the RMB becomes a freely tradeable, highly liquid international currency. In the interim, financial services companies who see commercial value in doing so may gain an "early mover" advantage through building up a brand name and presence in China and establishing commercial relationships with Chinese companies and consumers of financial products.
- The growing financial links between offshore RMB centres means that, increasingly, some forms of RMB-related activity can be undertaken in one centre but drawing on liquidity from other centres. This is the case for example with respect to trade-related RMB banking activity. Similarly, in the funds management sector, the manner in which the quota schemes providing access to Chinese capital markets have evolved means that local offshore RMB liquidity is not necessary in order to invest in China's capital markets.
- In other areas of offshore RMB activity however, such as capital markets, local liquidity would appear to be an important requirement.
- Most offshore RMB centres have arrangements in place for ongoing dialogues with China at an official and market level on RMB-related issues. These are very important, both in terms of building trust and understanding between market participants and officials in the two countries concerned and for discussing relevant policy issues.
- Many offshore centres also have in place domestic arrangements for the market sector to discuss and develop policy issues with the official sector, in order to ensure that key policy issues and constraints are identified and are being addressed.

Part Two: Sydney as an Offshore RMB Centre: Carving Out a Niche

- Complementarities in the structure of the Chinese and Australian economies augur well for increased RMB activity in Sydney and closer financial relations between Australia and China more generally over time. Amongst the most important ones are the following:
    - Australia is a capital importer, while China is a capital exporter and rapidly becoming a major one;
    - China is easily Australia's largest trading partner, while Australia is a larger supplier of Chinese merchandise imports than the major offshore RMB centres of Hong Kong, Singapore or the UK; and
    - China has substantial and rapidly growing savings pools that need to be invested in offshore assets, while Australia has a large, efficient and sophisticated funds management sector.

- Key areas that are identified in the report as providing scope for increased RMB-related business in Australia going forward are transactional banking business and funds management.
- With respect to banking, provision of trade-related RMB products and services is seen as a major growth area over coming years, boosted significantly by the expected shift towards RMB invoicing and settlement of much of our commodities trade with China.
- Another important growth area in the banking sector is likely to be provision of products and services for Australian companies looking to invest directly into China and Chinese companies looking to invest in Australia. In some cases, these and other banking services in China are being provided by Australian banks are being done through joint ventures with Chinese banks. However, one constraint on this front is the treatment of such capital investments under Australia's capital adequacy rules, which makes them very expensive compared to many other countries with which Australia is competing.
- With respect to funds management, a substantial increase in exposure to Chinese assets is highly likely over coming years as China further opens up its capital account and becomes a significant component of global benchmark indices.
- In terms of raising investable funds in China, the potential is enormous, reflecting the very large pools of savings and the increasing need for diversification of Chinese investments into offshore assets. At the institutional level, there is strong interest in investment in offshore infrastructure and real estate, two asset classes in which Australia has considerable expertise. Both larger Australian funds management companies and smaller boutique funds are increasingly taking advantage of emerging opportunities in this area.
- However, while the opportunities on this front are substantial so are the challenges. Some of the key ones identified in the report are:
    - Brand recognition and distribution of Australian funds in China. The report discusses in some detail alternative means of accessing investable funds in China with these two challenges in mind;
    - China's different approach to financial market regulation and the pace of regulatory change. Getting on top of this often requires a local presence in China;
    - Lack of the appropriate collective investment vehicles for selling funds into China and elsewhere in Asia. This is also critical with respect to development of the Asia Region Funds Passport; and
    - Lack of awareness by many Australian companies of the pace and direction of policy change in China and the related emerging opportunities. Raising awareness can bring increasing benefits down the track to Sydney and Australia more broadly.

One specific area of opportunity for increasing Chinese investment in Australia is the Significant Investor Visa and Premium Investor Visa programs. With the recent change in asset allocation requirements for the SIV program and the growth of fintech enterprises in Sydney, there may well be scope for attracting significant SIV investment into fintech ventures going forward.

Australia has in place a number of official level dialogues with China, including importantly the Financial Services Committee established under ChAFTA. If Australia is to maximise the opportunities available through the establishment of Sydney as an official RMB centre and the negotiation of ChAFTA, these dialogues need to be used effectively. Putting in place domestic structures to encourage more constructive exchanges between the official and market sectors on cross-border financial services policy issues could help considerably.

INTRODUCTORY COMMENTS

This research report focuses on how Sydney might best position itself as an offshore renminbi (RMB) centre to take advantage of the growing opportunities arising from China's opening up of its financial markets to the rest of the world. It builds on an earlier report entitled "Internationalisation of the Renminbi: Pathways, Implications and Opportunities", which provides considerable background information and analysis of relevance to this report [1].

This earlier report by the authors outlined the commitment of successive Chinese governments to pursuing a policy objective of internationalising their currency. Internationalisation of a currency is achieved when it is widely used, both inside and outside the home country, as a means of payment and for investment purposes, including as an international reserve asset. Internationalisation requires amongst other things opening up the country's capital markets to offshore investors, allowing its exchange rate to be market determined and deregulating domestic interest rates.

China has for some time allowed use of its currency in cross-border trade-related transactions but, while it is gradually liberalising its capital account, it still has widespread controls on cross-border use of RMB for non trade-related purposes, such as investment. As a consequence, two foreign exchange markets have developed: the offshore or CNH market, and the onshore or CNY market. There are no restrictions on the use of CNH within the offshore market.

Associated with this trade-related build-up of offshore RMB liquidity has been the development of a number of RMB centres and hubs[2] outside of mainland China focused both on facilitating cross-border trade-related CNY payments and providing a range of CNH products that can be used for investment and other purposes offshore. By both encouraging offshore use of RMB outside of China and providing a connection between the onshore and offshore markets, these RMB centres play a crucial role in China's gradual move towards internationalising its currency. In recognition of their importance, China has nominated a number of Chinese banks in various offshore RMB centres as "official" clearing banks for clearing trade-related transactions with mainland China. Centres with an official clearing bank have become referred to as "official" RMB centres.

China is now the world's largest trading nation and, on some measures, the largest economy. However, reflecting controls on the flow of capital into and out of China, its financial relations with the rest of the world are much more limited. As China continues to pursue its objective of RMB internationalisation and the associated opening up its capital markets, improvement of corporate

1 Eichengreen, Walsh and Weir (2014).

2 These two terms are used interchangeably throughout this paper, although the term 'hubs" is sometimes used to refer to smaller and more specialised offshore RMB centres.

governance and deregulation of interest rates and the exchange rate, this gap between its global trade links and its financial links will close rapidly.

These ongoing policy changes are likely to have a profound effect on the type, volume and location of financial flows and financial market activity over the next decade and beyond. Many financial centres are positioning themselves to benefit from the emerging changes and opportunities.

In Australia's case, taking advantage of these policy changes and the associated opportunities to build closer financial relations with China is a major priority of government, and considerable resources are being put into achieving this at both a federal and state level. It should be mutually beneficial to both countries, just as building closer trade relations has been.

With much of Australia's financial sector concentrated in Sydney, NSW in particular stands to gain. However, the keys to success in developing Sydney as an RMB centre lie first and foremost in the hands of senior management in financial services companies being aware of the speed and implications of China's move towards RMB internationalisation and the growing commercial opportunities that are emerging, and being willing to commit resources to achieving them. They also lie in the hands of the Federal Government, who are responsible for ensuring that Australia's tax and regulatory frameworks do not unnecessarily discourage cross-border financial relations and that ongoing negotiations with China on market access issues are productive. Thirdly, they lie in the hands of the State Government, which is responsible for ensuring that Sydney remains an attractive place for financial services companies to do business, with all the requisite infrastructure.

Reflecting these realities, this report is aimed at a wide audience, including the financial services sector and the State and Federal Governments. Part One of the report looks at what is happening in other offshore RMB centres and hubs and some of the key factors that are impacting on their success or otherwise. It then draws out some of the main issues for Sydney that warrant further examination. Part Two of the report drills down into these issues to more clearly articulate both opportunities and challenges. Both aspects are equally important: while the potential opportunities for building up closer financial relations with China are substantial, the challenges are also significant and need to be recognised and addressed if opportunities are to be realised.

The final chapter of the report sets out the main conclusions and recommendations.

PART ONE:

SOME LESSONS FROM OTHER OFFSHORE CENTRES

Part One of the report is based on meetings held throughout February 2015 in a number of official RMB centres - namely Singapore, Hong Kong, Seoul, Shanghai, Frankfurt, Luxembourg, London and Paris - and also on a wide range of further discussions with offshore and domestic contacts subsequent to that trip. Discussions were also held in New York and Washington. Since the trip was undertaken, four further official offshore RMB centres - Santiago, Budapest, Johannesburg and Buenos Aires - have been appointed.

CHAPTER ONE: How Have “Official” Offshore RMB Centres Been Chosen?

What have become known as the “three gifts”- namely a central bank swap facility for providing emergency RMB liquidity in the event of market disruption, an official RMB clearing bank for clearing cross-border RMB transactions and a Renminbi Qualified Foreign Institutional Investor (RQFII) quota for accessing China’s capital markets - have now been allocated by China to some 12 jurisdictions around the world (see Table 1.1). Of the three gifts, the establishment of an official clearing bank in particular is seen as official Chinese endorsement of the recipient jurisdiction as an offshore RMB centre. In total, including Macao and Taiwan, there are 18 offshore centres with official RMB clearing banks.

Table 1.1: Offshore RMB Centres: Swap Facility, RQFII Quota and Official Settlement Bank

Official Settlement Bank*				Swap Facility	RQFII
Date appointed	Country	City	Appointed bank	Current Value ¥ billion	Current Value ¥ billion
Dec-03	Hong Kong	Hong Kong	Bank of China	400	270
Sep-04	Macao	Macao	Bank of China		
Dec-12	Taiwan	Taipei	Bank of China		***
Feb-13	Singapore	Singapore	Industrial and Commercial Bank of China	300	50
Jun-14	United Kingdom	London	China Construction Bank	200	80
Jun-14	Germany	Frankfurt	Bank of China	350**	80
Jul-14	South Korea	Seoul	Bank of Communications	360	80
Sep-14	France	Paris	Bank of China	350**	80
Sep-14	Luxembourg	Luxembourg	Industrial and Commercial Bank of China	350**	50
Nov-14	Qatar	Doha	Industrial and Commercial Bank of China	35	30
Nov-14	Canada	Toronto	Industrial and Commercial Bank of China	200	50
Nov-14	Australia	Sydney	Bank of China	200	50
Jan-15	Malaysia	Kuala Lumpur	Bank of China	180	
Jan-15	Thailand	Bangkok	Industrial and Commercial Bank of China	70	
May-15	Chile	Santiago	China Construction Bank	22	50
Jun-15	Hungary	Budapest	Bank of China	10	50
Jul-15	South Africa	Johannesburg	Bank of China	30	
Sept -15	Argentina	Buenos Aires	Industrial and Commercial Bank of China	70	

* Only jurisdictions with at least an official settlement bank have been listed

** Luxembourg, France and Germany benefit from the currency swap agreement between the People's Bank of China and the European Central Bank

*** The allocation of Taiwan's RQFII quota is conditional on the finalisation of a prior trade agreement.

Some of the recipients, such as Hong Kong, Singapore and to an extent London, were already well established as offshore RMB centres prior to receipt of all three gifts. In other centres, however - including Sydney - the gifts have been granted more recently and recipients are at early stages of development as RMB centres or hubs.

The decision-making processes leading up to the granting of these gifts would appear to have been driven by a mixture of market and other factors. In some centres, such as Hong Kong, Singapore and London, the market case is clear. Hong Kong was the first offshore RMB centre to be established, and for nearly 10 years up until February 2013 had the only official offshore RMB clearing bank outside of Greater China. It has acted as the "pilot" project for all three gifts, which have only recently been extended beyond Hong Kong. Its Government and government agencies work closely with financial market participants in Hong Kong to promote the territory as a major financial centre, including with respect to its role as the most important offshore RMB centre. Its unique relationship with mainland China - including residents wanting to repatriate funds to the mainland and the presence of many Chinese companies in Hong Kong - has meant that, from both a market and a political perspective, it was always the logical first step in China's gradual process of RMB internationalisation.

Similarly with respect to Singapore[3], the economic case for its establishment as an offshore RMB centre is clear. As is the case in Hong Kong, government agencies and market participants have always worked closely together in an "all of government" approach to promoting and developing Singapore as a major financial centre and, more specifically, an RMB centre. This can be seen, for example, in the fact that in Singapore, as in Hong Kong, the central bank has put in place an RMB liquidity facility on the back of the central bank swap facility with the People's Bank of China (PBOC), with a view to facilitating and encouraging RMB market activity. In addition, given Singapore's traditional role as a trading and financial hub for South East Asia, the presence there of many Chinese companies and the widespread use of foreign currency deposits by Singaporean retail investors, the economic argument for Singapore being the second in line to receive the three gifts was compelling.

London is in a slightly different category. As a major international financial centre and the world's leading centre for foreign exchange turnover, the City of London was always likely over time to attract a significant share of offshore RMB transactional banking business. However, the first step by China in its pathway to RMB internationalisation was through the trade account and encouraging offshore companies to invoice and settle in RMB. Until recently, few companies in Europe invoiced and settled in RMB.

As a consequence, the market or economic case for bestowing the three gifts on the City of London only really gained momentum during the second phase of RMB internationalisation, namely gradual relaxation of capital controls and the growth in non trade-related offshore RMB

3 Key factors behind the success of Singapore and London as offshore RMB centres are discussed in more detail in Chapter Two.

transactions, such as for investment purposes. This is evident in the fact that the bulk of RMB turnover in London is non trade-related.

In addition, other considerations have worked somewhat differently in the case of London. For some time, the UK authorities saw little need for any of the three gifts and did not pursue them. Then, as both market and official views gradually changed, London sought and was eventually granted all three gifts in mid-2014.

Beyond these financial centres, the non-market dimension behind the granting of the three gifts has at times run ahead of the market case. By way of example, while the French authorities, including the Banque de France, have long held ambitions to attract financial services business from London and Luxembourg and become a major European financial centre, France's comparatively high tax rates and the relatively low ranking of Paris as a financial centre continue to make this difficult to achieve. While China is an important trading partner for France, the fact remains that, so far as competing with other continental European countries with ambitions to become RMB centres goes, RMB liquidity in Paris remains low compared to Luxembourg, while the value of trade between Germany and China is substantially larger than that for France.

Despite these limitations, the French authorities have actively supported and pursued the development of Paris as an RMB centre. An additional motivation behind this would appear to be the view in at least some parts of the official sector that, for both geopolitical and financial stability reasons, the world needs to move away from its overreliance on the USD as the pre-eminent global reserve currency; the euro and (over time) the yuan[4] are natural candidates for such a challenge to the supremacy of the USD; and France needs to be directly involved in international developments and discussions in pursuit of this objective.

Another interesting example of the interplay between market forces and other considerations with respect to offshore RMB centres and distribution of the "three gifts" is New York. Neither the U.S. Government nor U.S. financial market participants have actively sought these gifts; nor have they been offered by China. In their absence, Canada sought and was granted the three gifts, in late 2014.

From a market perspective, the main reasons why there has not been any U.S. push to be granted some or all of the three gifts would appear to be the following:

- with the USD still the pre-eminent global currency, most multinational US companies do the vast bulk of their business in USD and see little need to run multicurrency treasury operations, which would be expensive to establish;
- many of the larger US domiciled banks have a significant presence in Asia, including in some cases in mainland China, and can readily transact in RMB through these overseas operations if they need to; and

4 The official name for China's currency is the renminbi (RMB). The yuan is the unit of account.

- for the funds management sector, the large global players typically have a presence in other countries which have been granted RQFII quotas and are able to utilise these overseas quotas in a flexible and fungible manner, to gain the access they require to China's capital markets. For the smaller U.S. funds management companies, most have shown limited interest to date in accessing China's capital markets.

At the official level within the U.S., there would also appear to be a number of factors at play behind the lack of any request to receive the three gifts. Firstly, there has been little market demand for them to date, and the typical official sector view is that any such request should be market led. Second, there would appear to be a view amongst some if not many U.S. government officials focused on China that, while some progress has been made, it will take decades before the RMB becomes a major international currency, so there is no hurry. Thirdly - and probably related - there is an underlying hope in some quarters at least that China does not succeed or has at best limited success, given the "exorbitant privilege"[5] that the U.S. has received from being the pre-eminent international reserve currency.

One consequence of the fact that decisions regarding the size and geographic distribution of the three gifts have at times been driven by non-market factors is the still limited take-up of RQFII quotas. As at the end of September 2015 the State Administration of Foreign Exchange (SAFE) had awarded RMB 412 billion in RQFII quotas to 141 institutions representing only 42% of the total RQFII quota[6]. If RQFII licences had not been "portable" across jurisdictions, so that a company with a presence in one country that has a quota can utilise it in another country that does not, then the take-up would be even lower.

5 This term, which was originally coined in the 1960's by the then French Finance Minister, Valery Giscard d'Estaing, refers to the substantial benefits the US has obtained from being the primary international reserve currency.

6 Source: SAFE

CHAPTER TWO:
The Transition Period to RMB Internationalisation and "Early Mover" Advantages

What Will RMB Internationalisation Look Like?

As noted earlier, because China has no restrictions on cross-border flows of its currency for trade-related purposes but still has significant controls on cross-border flows for investment purposes, two foreign exchange markets have developed: the offshore or CNH market, which can be freely used for offshore investment and other purposes, and the onshore or CNY market, which remains subject to capital controls. As capital controls have been gradually relaxed, the links between these two markets have increased and they have increasingly moved in close tandem.

Ultimately, once the RMB has been internationalised, there will be no distinction between offshore RMB (CNH) and onshore RMB (CNY). Official offshore RMB settlement banks will be largely redundant, as all banks will have ready access to RMB for both trade and non-trade purposes. RQFII quotas will also be redundant once capital controls are removed, and RMB swap agreements between central banks will be less relevant except in periods of major market disruption, as liquidity will be more readily and widely available through both trade and capital account transactions. The RMB will then be no different to any other freely tradeable currency - apart that is from the sheer volume of turnover, reflecting the size of China's economy, global trade links and capital markets.

As with other freely tradeable currencies, once the RMB is internationalised the distribution of RMB transactional business around the world will be market determined. Outside of mainland China, a good deal of RMB business will tend to gravitate to where the pools of liquidity are, with the Chinese central bank being the ultimate source of global liquidity.

But what about the time period and pathway from where we are now to when the RMB has become internationalised? What will be the role of the "three gifts", and of market as against other forces, in influencing the distribution of RMB business amongst the growing number of competing financial centres and hubs?

Length of Time for RMB Internationalisation

An important component in answering this question is how long it will take for China to internationalise its currency. Internationalisation of the renminbi requires the removal of capital controls, removing the ceiling on bank deposit rates[7], moving to a market determined exchange rate and seeing the RMB become widely used as an international reserve currency and in trade and investment transactions outside of mainland China. The faster RMB internationalisation happens, the less relevant are the "three gifts", both now and looking forward; and the less "early mover" advantage there is for companies from building up RMB expertise and clients now, or from gaining access to China's capital markets now. If the RMB will soon be like any other major convertible currency and China's capital account will be wide open for business, then a legitimate question is: why go to all the trouble and expense of navigating the current complex web of capital controls and exemptions?

In the authors' March 2014 report "Internationalisation of the Renminbi: Pathways, Implications and Opportunities", it was suggested that a realistic timeframe for the Chinese currency becoming internationalised in the sense described above was around ten years.[8] Developments since then have tended to work in opposite directions. On the positive side, further capital account liberalisation initiatives have occurred faster than we had anticipated, in particular via the Shanghai-Hong Kong Stock Connect Scheme; the widespread distribution of RQFII quotas; the significant relaxation of controls on direct foreign investment flows; and the relaxation of controls on RMB sweeping facilities between a company's operations inside and outside of mainland China. Experimentation with further liberalisation measures in both established and new free trade zones such as the Shanghai Free Trade Zone (SFTZ) is also increasing (see Appendix 1.1). In addition, and in part related to the distribution of the "three gifts", competition amongst financial centres to build up offshore RMB business has intensified faster than we had anticipated.

The pace of policy change in China suggests that, in the absence of a major economic or political setback, most of China's capital controls could be removed, its currency floating and bank interest rate controls removed considerably earlier than in 10 years. China will also by then represent a very large component of a range of global benchmark indices used by fund managers.

However, our earlier report noted that, for RMB internationalisation to fully succeed, offshore investors need not only access to China's capital markets but also confidence in them[9]. Without both access and market confidence, the use of RMB in offshore investment and financial transactions will be more limited. Such confidence extends to areas such as the rule of law

7 In August 2015 China partially lifted its ceiling on bank deposits, but only for deposits of longer maturity than one year.

8 Eichengreen, Walsh and Weir (2014) pp. 68-69.

9 Eichengreen, Walsh and Weir (2014), p. 74.

and dispute settlement procedures; the financial services regulatory structure in China; and the quality of corporate governance.

With respect to the first two dimensions of such confidence - rule of law and regulatory structure - the SFTZ has the potential to act as an important trial for simpler and more transparent arrangements. However, this is an area of ongoing experimentation and change in China, and it remains to be seen how effectively these new arrangements in the SFTZ operate over time (see Appendix 1.1).

With respect to corporate governance, this was seen in the authors' first report as a very important step along the pathway to RMB internationalisation. However, progress on this front has been slower. Moves have been made to make it easier and faster for Chinese SME's to list on domestic stock exchanges. In addition, measures have been undertaken to inject private sector capital into state owned enterprises (SOE's). However, these private sector investments in SOE's have rarely if ever involved majority ownership or control. Furthermore, the counterproductive nexus between non-financial SOE's and the state-owned banks - which provide the former with easier access to bank loans - remains, despite attempts by the Chinese authorities to encourage greater lending to the private sector SME's (for example, via lower bank capital reserve ratios against such loans). The state-owned banks continue to view SOE's as a better credit risk, regardless of how they are using the borrowed funds, because they are perceived as being government guaranteed. In part, this reflects inadequate development of credit risk skills and expertise in many Chinese banks.

This is a difficult area for the Chinese Government. Representation on SOE boards by party officials and state influence over SOE activities is seen by some senior Communist Party officials as an important component of Party influence in the economy and society, and not something they would easily relinquish. But greater reform in this area remains vital if the Government is to succeed in its objective of internationalising the currency, opening up China's capital markets and improving domestic resource allocation.

Another relevant question in thinking about pathways and timetable for RMB internationalisation is what the volatility in the Chinese domestic equity market earlier this year means for capital account liberalisation in China going forward.

The very large daily falls witnessed on China's domestic equity market around the middle of 2015 were not unprecedented - there had been daily falls of a similar magnitude in February and June 2007 and in January 2015, for example. However, what was unusual in the context of China's commitment to RMB internationalisation and greater reliance on market forces was the nature of the policy response taken, which included amongst other measures:

- banning sales by large shareholders;
- share purchases by state owned enterprises;

- credit lines from the central bank to margin financing companies; and
- suspension of trading in, at one point, over half of the listed companies on the Shanghai and Shenzhen stock exchanges [10].

While speculative, the extent and nature of this policy response may have reflected a number of factors, including:

- Concerns about the macroeconomic impact of sharp falls in the equity market in the context of already weakening growth (although this should not be exaggerated given that domestic equity holdings only represent a small proportion of household wealth in China); and
- Concern about offshore confidence in China's capital markets in the context of China's ongoing move towards capital account liberalisation. The Chinese authorities are very aware that successful RMB internationalisation requires not just offshore investor access to China's capital markets but also confidence in them, and it has been keen to see Chinese assets included in investor benchmark indices.

Some of the measures taken by the Chinese regulators, such as a ban on short selling, have been used in a number of other countries - including western economies - at times of financial stress. However, the full range and extent of the measures taken by the Chinese authorities arguably reflects a more ambivalent attitude towards relying on market forces and accepting any accompanying volatility.

China's evident concern with respect to periods of substantial market volatility may have a number of implications for the process of RMB internationalisation and capital account liberalisation going forward.

Firstly, in the short term it may slow down the pace of capital account liberalisation. In particular, and accompanied by some concerns and uncertainties surrounding China's devaluation of the yuan in August 2015 and move towards a more market determined setting of its daily reference rate for the yuan, the Chinese authorities have recently tightened up controls on capital outflows.

Secondly, it may lead to some re-ordering of policy priorities associated with RMB internationalisation. In particular, it may lead to a greater focus on domestic market reforms - such as improving market regulation and dealing with the shadow banking sector - ahead of any additional substantial capital account opening measures.

Thirdly, the experience may also encourage internal debate in China as to exactly what sort of end point they are aiming for with RMB internationalisation - or, to put it slightly differently, just what they mean by having a "floating" exchange rate and an "open" capital account. China may decide to maintain some capital controls and some exchange rate management.

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10 Grigg (2015)

In conclusion, the recent experience of market volatility and the nature of the Government's response suggest that the process of capital account opening may slow down somewhat for a period, and the sequencing of policy changes may alter. At this stage, however, it seems unlikely to derail the overall process. The pace of capital account liberalisation has in fact been extremely rapid since it received strong endorsement at the 2013 Third Plenum of the Chinese Communist Party, and any slowdown in market opening measures needs to be seen in that context.

Unless the speed of corporate governance and rule of law reforms in China accelerates, it may well be that, in terms of official policy settings, China has a largely open capital account and a floating currency within five or so years but that, in terms of market response to this openness, it takes somewhat longer before the RMB is very widely used for private sector investment purposes - that is, before it is fully internationalised.

While it is entirely a matter for commercial judgement - and the weighting of pros and cons will vary from company to company – five to ten years would certainly seem to be a long enough period for those financial services companies who wish to do so to establish or enhance an "early mover" advantage. Financial services companies that build up early links with corporate customers trading with China, establish business relationships with mainland Chinese companies or seek out early opportunities to manage capital coming out of China may be in a much stronger position once capital controls are removed and the RMB becomes internationalised. However, this is far from guaranteed: many companies, financial and non-financial, that moved early to establish a presence in mainland China have found it an expensive and to date unrewarding experience.

The Pace of Policy Change

Another relevant factor in weighing up the pros and cons of seeking an "early mover" advantage in relation to RMB internationalisation is the pace of policy changes with respect to opening up of "windows" in China's capital controls. This is having an impact on the way in which overseas financial services companies are thinking and operating. Larger international companies are in some cases using a number of windows or mechanisms and then, as it becomes clearer which avenue is opening fastest and over time is most likely to suit their needs, channelling more resources into that one. This, however, requires plenty of resources.

For smaller companies that do not have the resources, the best strategy in the short term may be to wait and see how these various windows in the capital account expand and develop. In the process, however, larger, better-resourced and better- informed companies may have stolen the march on them.

One of the conclusions that many would reach from observing the rapid pace of policy change in China, be it in funds management or in other areas of financial services, is that there is no substitute for having a presence on the ground in mainland China that enables you to keep in *close contact with the relevant government officials and have a good feel for policy developments and prospects.*

Working closely with government officials from your country of domicile who are based in mainland China and are themselves in close contact with Chinese officials may also be very useful, a point returned to below.

The Importance of the Three Gifts

For companies that are looking to take advantage of this transitional period ahead of RMB internationalisation, how important will the three gifts be in attracting offshore RMB activity to the centres that have received them?

Looking firstly at central bank swap agreements, most but not all central banks view this as for use only in times of severe market disruption, should liquidity dry up. However, Chapter One noted that a few central banks in those locations where the official sector is much more actively engaged in promoting market development have put in place mechanisms to provide market liquidity on the back of this official swap facility, with a view to encouraging RMB business development rather than just dealing with emergencies. This is probably clearest in the case of Hong Kong, where the facility, entailing a group of nominated market makers in RMB liquidity, is reasonably actively used, with the encouragement of the Hong Kong Monetary Authority[11].

In the case of Singapore and Seoul, while the intention of the central banks in both cases would also appear to go beyond mere emergency use, the facility is not widely used at present, in part because it is seen as expensive by the market and in part because of a perceived stigma if a bank draws on it. These drawbacks may see adjustments made to the facilities going forward.

In short, the RMB swap facility may to some extent be a source of market confidence with respect to the availability of RMB in the event of some market disruption, but beyond that it will only be a competitive advantage in those few jurisdictions where central banks see it as their role to encourage and facilitate market transactions.

With respect to official RMB clearing banks, the authors' earlier report argued that they may also provide an element of market confidence regarding liquidity but that, given the existence of a range of other quite efficient RMB clearing mechanisms, they were not of central importance[12]. Following discussions with both official and market participants in a number of offshore RMB centres, this remains our view, and for the same reasons. In addition, it would appear that, in

11 In late 2104 the Hong Kong Monetary Authority (HKMA) designated seven banks as Primary Liquidity Providers (PLPs) for the offshore RMB market in Hong Kong. These designated PLPs have undertaken to expand their market-making activities in Hong Kong for various CNH instruments and use the Hong Kong platform in promoting their global offshore renminbi business. In return, the HKMA provides a dedicated repo facility of RMB2 billion to each of the PLPs so as to facilitate more efficient liquidity management when they carry out market-making and other business activities in the CNH market.

12 Eichengreen, Walsh and Weir (2014), pp. 90-91.

some centres at least, the fact that implementation of the new Cross-Border Interbank Payments System (CIPS) was in the pipeline has discouraged official clearing banks from spending much on developing their clearing infrastructures. More generally, as the PBOC has now launched the first phase of CIPS[13], the relevance of these official clearing banks is expected to diminish. Box 1.1 below outlines the CIPS cross-border payments system.

Box 1.1 China's Cross-Border Interbank Payments System

China's payment system is undergoing a significant upgrade with the recent launch of the first phase of the new CIPS, which has been designed specifically to facilitate cross-border use of RMB for trade settlement and other purposes.

The new system will operate in a similar way to the USD clearing system, the Clearing House Interbank Payments System (CHIPS), by providing direct clearance between offshore and mainland China participants. It will allow the use of both Chinese and English characters and will also adopt international standard messaging. Direct access is expected to significantly reduce transaction costs and processing times. Nineteen banks, eight of which are foreign including one Australian bank, were announced in the first batch of direct participants. Other eligible banks can apply to the PBOC for direct participation or can access the network via a direct participant. CIPS will operate through key business time zones covering Europe, Asia, Africa and Oceania.

Existing clearing and settlement mechanisms will continue to operate. However, once fully rolled out CIPS is likely to significantly reduce the importance of official RMB clearing banks.

Nonetheless it would seem that, in one or two RMB centres - most notably Singapore - establishment of an official clearing bank did encourage greater use of RMB for trade settlement purposes. The reason in the case of Singapore was that, while a number of banks had the capacity to efficiently clear RMB transactions prior to establishment of ICBC as the official clearing bank, none of them widely advertised or promoted the fact. The announcement of an official clearing bank changed that and raised awareness amongst corporates and others of the benefits of and scope for RMB invoicing.

Another element in considering the importance or otherwise of official clearing banks is whether they represent a source of additional RMB liquidity. This could be the case, for example, if the

13 The first phase of CIPS was launched on 8 October 2015. Its potential importance is discussed in more detail in Part Two Chapter Four.

clearing banks had access to more RMB liquidity than the non-clearing banks via either their other branches or the central clearing bank in Hong Kong (the only one apart from Macao to have direct access to China's real-time gross settlement system (CNAPS), the onshore Chinese payments system); and they were prepared to use this access to provide liquidity to other banks that have accounts with them.

However, this is another area where the distinction between non-market considerations and market driven behaviour starts to blur. In a number of centres, local banks have set up accounts with the official clearing bank. However, in many cases they did so in response to encouragement by the official sector, with little or no intention to use them as a source of liquidity. Competition for business, RMB or otherwise, between banks - including between Chinese banks - is strong and can act as a disincentive to being seen to rely on the official clearing bank for liquidity except in extreme conditions.

Turning to the third gift, namely allocation of RQFII quotas which allows approved fund managers to access mainland China's capital markets up to their share of the overall quota, developments in this area have been interesting. International funds management companies with a presence across a number of financial centres have been able to access RQFII allocations in more than one jurisdiction and then treat them as fungible, combining allocations where they wish, managing the funds in other locations and selling them across a range of countries, denominated in a range of base currencies. The jurisdiction of the quotas has thus become less relevant.

In general, however - apart from Hong Kong, where the quota has now been fully utilised - the take-up of quotas has been slow. Once again, this reflects the fact that the allocation of RQFII quotas in terms of size and location was in many cases driven by a range of factors.

In summary:

Receipt of the three gifts may be important in terms of:

- *increasing market confidence that both the Chinese Government and the Government in the beneficiary country stand behind development of local RMB activity, and hence liquidity will be available in the event of an emergency;*
- *raising market awareness of the possibilities and potential advantages of transacting in RMB; and*
- *signalling China's support for building up offshore RMB business in these centres, including possibly by way of further policy changes.*

Beyond these considerations, however, receipt or otherwise of the gifts is not likely to prove critical to the success or otherwise of building up RMB business in a particular centre.

CHAPTER THREE: Pathways to RMB Internationalisation and their Likely Impact on the Distribution of Offshore RMB Activity

Any discussion on the route to RMB internationalisation is to some extent inherently speculative, as there are many different potential pathways between where policy settings are now and internationalisation. However, in the absence of any major economic or political crisis - an important caveat, as either could affect not just the pathway to achieving RMB internationalisation but also the Chinese Government's commitment to it - a good deal of guidance can be gained from examining China's approach to date.

That approach has involved a series of "pilot" or trial projects, usually centred initially on Hong Kong, which if successful have then been rolled out to other offshore centres beyond Hong Kong. This has been the model with respect to RMB trade invoicing; official clearing banks; outward bound investment quotas such as the Qualified Domestic Institutional Investor (QDII) scheme; and offshore RMB bond issuance.

It seems reasonable to assume that the same model will be used going forward. Consequently, over coming years it is likely that we will see:

- the Shanghai-Hong Kong Stock Connect Scheme being extended to both other exchanges in China such as Shenzhen and also to other offshore stock markets, with Singapore the most likely next connection;
- increased quotas with more flexible investment requirements for portfolio investment flows both into and out of China being allocated to some offshore financial centres;
- the mutual recognition treaty between China and Hong Kong being rolled out to other financial centres;
- further increases in the exchange rate band within which the onshore currency (CNY) is allowed to fluctuate, which will encourage more Chinese companies to invoice and settle in RMB, and additional moves towards greater market determination of the rate;
- continued rapid growth in both Chinese direct investment in a wide array of overseas countries and in foreign direct investment flows into China; and
- the experiments currently being conducted within the Shanghai Free Trade Zone (see Appendix 1.1) being extended to the whole of China.

In addition, the next few years will likely see the further rollout of CIPS. Once fully operational, this new RMB clearing platform will provide a direct and more efficient mechanism for all member banks in clearing offshore RMB transactions, and over time will likely make official RMB clearing banks largely redundant.

Looking at the overall impact of these and related developments:

It seems very likely that, during the ongoing move towards RMB internationalisation, we will see a further growing proportion of total offshore RMB business gravitate away from Hong Kong and towards other centres, as Hong Kong's special status is eroded - including the role played by the Bank of China (Hong Kong) as the first and pre-eminent offshore clearing bank. In addition - subject to the very important caveat discussed earlier regarding rule of law and corporate governance reform - Shanghai is likely to play an increasingly important role as a capital raising centre and the source of offshore RMB liquidity, further eroding the role played to date by Hong Kong.[14]

In short, the pathway to RMB internationalisation will likely provide increasing opportunities for greater offshore RMB business in centres beyond Hong Kong, including Sydney.

14 The Chinese Government has on a number of occasions expressed its objective of Shanghai becoming a major international financial centre by 2020.

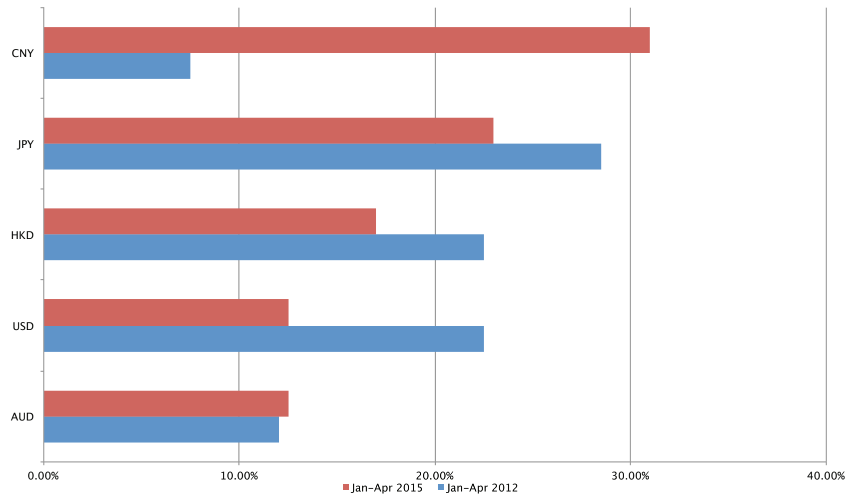
CHAPTER FOUR:
Key Determinants of Successful RMB Centres

Given their advantages, it seems likely that Singapore and London would have continued to grow as offshore RMB centres even in the absence of the “three gifts”. Thinking about why that is the case helps highlight some of the key determinants of larger successful RMB centres.

The answer is a mixture of history, market expertise and liquidity - and some supportive government policies. Looking at Singapore first, the really critical factors behind its development as an RMB centre have been the historical role it has played and continues to play as a regional trading (including commodities trading) and foreign exchange hub; the presence of a large number of Chinese companies in Singapore; the fact that it is in the same time zone as Shanghai; the low tax rates and other incentives provided by the Singaporean Government for companies to set up regional treasury operations there and for financial market participants to work there; and the fact that Singaporean investors, including retail investors, are significant holders of foreign currency deposits, including RMB deposits.

These factors in combination have meant that Singapore has a large number of “natural holders” of RMB-denominated assets, such as retail investors holding RMB-denominated bank deposits and other instruments and Chinese companies holding RMB on their balance sheets. Singapore’s historical role in the region means it is also a critical hub for many of the supply chains in Asia that are linked one way or another into China[15]. Increasingly, this intraregional trade is being invoiced and settled in RMB (Figure 1.1).

Figure 1.1: Currency Weight Evolution Within Asia for Payments with China and Hong Kong (payments by value)



Source: SWIFT

15 See on this point Eichengreen, Walsh and Weir (2014) insert pp 58 - 61.

Turning to London, there are, unlike Singapore, few natural holders of RMB-denominated assets, either at the retail investor level or the corporate level. As a consequence, on at least one measure it is not a major centre of RMB liquidity: total RMB deposits in London, including interbank deposits, are still small. However, London has for a long time been the largest global foreign exchange centre, with many continental European and other banks pricing and transacting foreign exchange business via their office in London or via a correspondent bank in London. These longstanding global banking and corporate links into the City of London have been a critical factor in its rapid growth as an offshore RMB foreign exchange trading centre - much more so than the receipt of the three gifts. In addition, albeit much less so than in Singapore, government policies have long been in place to encourage expatriates to work in the City and elsewhere.

What about other, smaller centres that have received the three gifts? In essence, their fate as RMB centres will also be market determined - although government policy settings with respect to financial services regulation and the tax treatment of cross-border financial flows can help or hinder such development, an important consideration which is returned to in the second half of the report.

Box 1.2 below provides an example of a centre that has successfully carved out such a niche, namely Luxembourg.

For these smaller RMB centres, developments to date suggest that a key to success lies in their capacity to carve out a "niche" for themselves, based on their own unique characteristics and market strengths. This may be a combination of factors, such as time zone and geographical location, trade links, or a history of specialising in particular areas of financial market activity. Market friendly tax and regulatory structures have also played an important role.

Box 1.2: How Has Luxembourg Succeeded as an RMB Centre?

Luxembourg is a founding member of the EU, a member of the Eurozone and, geographically, situated at the heart of Europe. As an international financial centre, it provides a business friendly tax and regulatory environment and an "all of government" approach to encouraging financial services business. It is also the biggest funds management licensing and distribution centre in Europe.

Luxembourg's very small size and population have meant that it could not rely on its trade with China as the basis for building up RMB business. Instead, it has focused on non-trade financial transactions. Luxembourg has a long history of working closely with China to develop two-way financial flows between the two countries. By way of example on the funds management side, an MOU signed between regulatory agencies in the two countries as early as 2008 allowed QDII's - vehicles for allowing Chinese investors to invest into some foreign markets and products - to invest in Luxembourg registered investment vehicles.

More recently, the majority of Chinese fund managers who have launched investment funds in Europe through their Hong Kong subsidiaries have selected Luxembourg as the domicile for their funds. Luxembourg is the largest domicile in Europe for Chinese equity ETF's.

On the capital markets side, the Luxembourg Stock Exchange has long been an important centre for international bond listings, and was the first location outside of greater China for issuance of a commercial dim sum bond[16] - by Volkswagen in May 2011. It has since become the primary European location for dim sum issuance, listing and secondary market trading, with 40% of total European dim sum issuance. It is now the fourth largest centre for dim sum bond issuance globally.

Luxembourg has become the European headquarters for a number of major Chinese banks including ICBC, the local RMB clearing bank. Chinese banks tend to use Luxembourg as their regional centre for granting RMB commercial loans to their European customers. It has also become the European headquarters for a number of Chinese non-financial companies. These have been important factors behind the build-up of RMB liquidity in Luxembourg, which now has the largest RMB deposit base in Europe.

16 A dim sum bond is an RMB-denominated bond issued outside of mainland China.

In contrast to Luxembourg's success in carving out a niche for itself, some financial centres that have been granted the three gifts have overlapping models for building up RMB business which may limit their effectiveness, particularly when they are in the same geographic region. Frankfurt and Paris are good examples. The Bundesbank has been actively involved in discussions and negotiations over developing Frankfurt as an RMB centre, although since around 2012 the Ministry of Economics has been the key driver at the official level. The official sector's motivation would appear to be twofold: to facilitate trade between Germany and China and assist German companies wanting to invoice and settle in RMB; and more broadly to see Frankfurt grow and develop as a financial centre. The perceived mechanism for building up RMB business is trade: the German model is to encourage major companies to have their treasury operations in Germany, to facilitate greater RMB invoicing by these companies, and then to develop greater local liquidity and a wider range of RMB-denominated financial products on the back of this.

The 'positives' for Germany in pursuing this approach include firstly the volume of their trade with Germany (Germany is China's sixth largest trading partner); and secondly the fact that many of the large multinational German companies trading with China, such as Volkswagen, are used to running multi-currency treasury operations, have a significant presence in mainland China and hence (if invoicing in RMB) are more likely to hold RMB on their balance sheets.

The 'negatives' include the strong competition for foreign exchange business from London; and the fact that a very large proportion of German exports to China are not from large multinationals but from "mittelstand" or SME's who often do not have a significant presence in China and hence are less inclined to hold any RMB obtained via trade settlement on their balance sheet. In addition, while Frankfurt would like to attract RMB bond issuance and trading, they face strong competition from Luxembourg on this front.

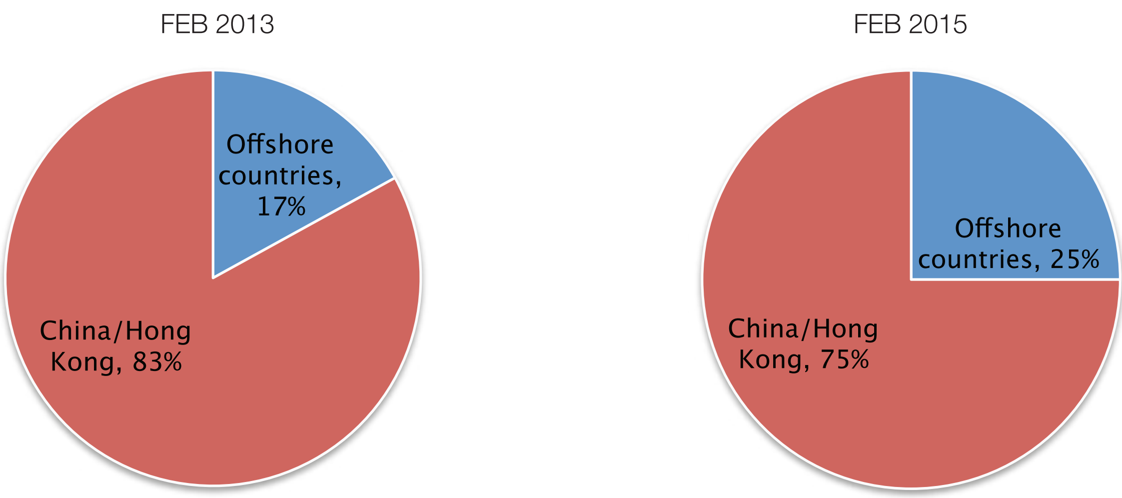
In the case of Paris, its development as an RMB centre also has the strong support of the central bank and for similar reasons. The model is also very similar: to encourage French multinationals and SME's trading with China to have their treasury operations in France and to invoice in RMB, and then to build local liquidity and product on the back of this. Paris has a number of advantages: China is a significant export market for France, albeit not nearly as significant in absolute terms as is the case for Germany; many large French exporters have a sizeable presence in China; and France to some extent acts as a hub for companies in North Africa and parts of southern Europe that are trading with China. The disadvantages are again competition from London and Luxembourg; and more broadly the relatively low ranking of Paris as a financial centre, for a range of reasons.[17]

17 See for example the March 2015 Global Financial Centres Index, which ranks Paris 37th after London (2), Zurich (6), Geneva (13), Luxembourg (17), Frankfurt (19) and Vienna (35).

CHAPTER FIVE:
How Important to Success is Local RMB Liquidity?

Due to its special relationship with mainland China, its "first mover" advantage and the existence of widespread natural holders of RMB-denominated assets, Hong Kong is the primary source of offshore (CNH) liquidity. Increasingly however, as capital controls have been relaxed, as trade and capital account-related RMB transactions have gravitated beyond Hong Kong and as the range and depth of CNH financial products have increased, other centres of liquidity have developed (Figure 1.2). The largest have been Singapore, Taiwan, Luxembourg and London.

Figure 1.2: Offshore RMB Payments by Value



Source: SWIFT

As a consequence, overall offshore CNH turnover and liquidity have risen significantly in recent years. Much of the increased turnover has been for hedging, both for trade and non-trade purposes. While intraday liquidity can still sometimes be an issue, the offshore deliverable forwards market has become an important source of turnover and liquidity, especially in London. Anecdotal evidence and discussions suggest a large proportion of turnover in the forwards market has been speculative as against trade-related.

Table 1.2 below provides some measures of overall offshore RMB liquidity and turnover and compares it with onshore (CNY) turnover.

If over time they become more widely used, both Shanghai-Hong Kong Stock Connect outflows from China and outflows via the (Renminbi Qualified Domestic Institutional Investor) RQDII quota scheme (which allows mainland Chinese investors to invest in offshore RMB products) may become important sources of offshore liquidity.

Table 1.2: RMB Activity Indicators in the Onshore and Offshore Markets

	Offshore Deliverable RMB (CNH Market)	Onshore Deliverable RMB (CNY Market)	Offshore Non-Deliverable RMB
Spot	USD35bn daily trading volume	USD30bn daily trading volume	Not applicable
Forwards / FX Swap	USD40bn daily volume. Liquidity up to 10 years	USD 5-10bn daily trading volume, up to 5 years	Non-deliverable forward (NDF) / Non-deliverable Swap. USD5bn daily trading vol., up to 5 yrs.
FX options	Actively traded. Daily average notional USD1.5bn	Very early stage, still pending more uptake	Actively traded
FRAs	May start trading soon	May start trading soon	Very illiquid
Interest Rate swaps	Corporates increasingly using CNH IRS to hedge their RMB liability interest rate risk. CNH IRS up to 5y but mainly trade out to 2y in small sizes	Actively traded. Available as Repo IRS, Shibor IRS, Depo IRS etc. Onshore IRS trade out to 5y	Actively trade by financial institutions
Cross currency swaps	USD 500-800mm per day, mostly out to 5y tenor but liquidity is available up to 10Y. Liquidity has grown rapidly as CNH CCS is now a widely used instrument for bond issuance hedging and multinational corporate hedging	CCS is allowed to be traded by Corporate for hedging purpose. Liquidity is available up to 5 years	Non-deliverable CCS, actively traded
Structured products	CNH market can offer a variety of structured products which are linked to FX, Interest rates, Credit, Commodity and Equities, in the format of OTC derivatives as well as securities.	CNY European Vanilla option and combination can be traded by Corporate.	Market can offer a variety of structured products which are linked to FX, Interest rates, Credit, Commodity and Equities. Volume has declined since proliferation of CNH structured products.

Source: Lee (2014); Standard Chartered Bank, Oct 2015

Associated with the pickup in offshore RMB liquidity has been increased CNH flows between offshore centres.[18] This likely reflects a wide range of factors but most importantly the fact that, while offshore RMB business is increasingly spreading beyond Hong Kong to other RMB centres, liquidity is very unevenly distributed amongst these other centres.

What has thus built up to date is something of a "hub and spoke" network of offshore RMB centres, with the smaller ones – such as Paris, Sydney or Frankfurt – drawing on larger pools of liquidity in Hong Kong, Singapore or London.

These developments are reflected in, for example:

- national and international banks, including offshore Chinese banks, drawing on liquidity internally from their branches in the larger RMB centres as needed and/or consolidating management of their RMB holdings in the larger centres. An example of the latter is ICBC Luxembourg, which is the local clearing bank but also acts as the European centre for ICBC in terms of holding RMB bank deposits on behalf of branches elsewhere in Europe ; and
- increased correspondent banking business, with smaller banks drawing RMB liquidity from larger banks that in turn draw it from their branches in the major RMB centres.

Table 1.3 below provides an indication of the uneven spread of RMB liquidity and turnover in different centres. Unfortunately, most of these data are not as yet available for Australia.

18 There are few reliable data on the volume, nature and direction of flows between offshore RMB centres (see Part Two Chapter Eight). However, it is clear from discussions with a wide range of market participants that these flows have increased significantly in recent years.

Table 1.3: Comparison of RMB Activity Across Different Centres

RMB Centres (Asia)	Hong Kong	Singapore	Taiwan	Korea
RMB deposits	¥979 bn (Aug 15)	¥322 bn (Jun 15)	¥326 bn (Aug 15)	¥68 bn (Aug 15)
RMB loans	¥188 bn (Dec 14)	n.a.	¥22 bn (Aug 15)	n.a.
RQFII quota/used amount (Jul 2015)	¥270 bn/¥270 bn	¥50 bn/¥29 bn	¥100 bn/-	¥80 bn/¥49 bn
Number of listed RMB bonds (Nov 2014)	148	74	30	-
Average daily trading volume of RMB foreign exchange (Apr 2013)	$49 bn	$24 bn	$3 bn	$0.2 bn
Designated RMB clearing and settlement bank	BOC	ICBC	BOC	BoComm
Currency swap with China	¥400 bn	¥300 bn	-	¥360 bn
RMB Centres (Europe)	**Luxembourg**	**United Kingdom**	**France**	**Germany**
RMB deposits	¥62 bn (Dec 14)	¥20 bn (Dec 14)	¥25 bn (mid 14)	¥12 bn (Mar 15)
RMB loans	¥61 bn (Dec 14)	n.a.	n.a.	¥12 bn (Mar 15)
RQFII quota/used amount (Jul 2015)	¥50/-	¥80 bn/¥21 bn	¥80 bn/¥15 bn	¥80 bn/¥6 bn
Number of listed RMB bonds (Nov 2014)	47	17	5	3
Average daily trading volume of RMB foreign exchange (Apr 2013)	$0.4 bn	$24 bn	$1.1 bn	$0.5 bn
Designated RMB clearing and settlement bank	ICBC	CCB	BOC	BOC
Currency swap with China	¥350 bn	¥200 bn	¥350 bn	¥350 bn

Sources: Bank of Korea, Bundesbank, CEIC Data, Central Bank of the Republic of China (Taiwan), City of London, International Monterary Fund (IMF), Luxembourg for Finance, Monetary Authority of Singapore, PBOC, Paris Europlace, SAFE, PWC Market Research Centre.

As can be seen from Table 1.3:

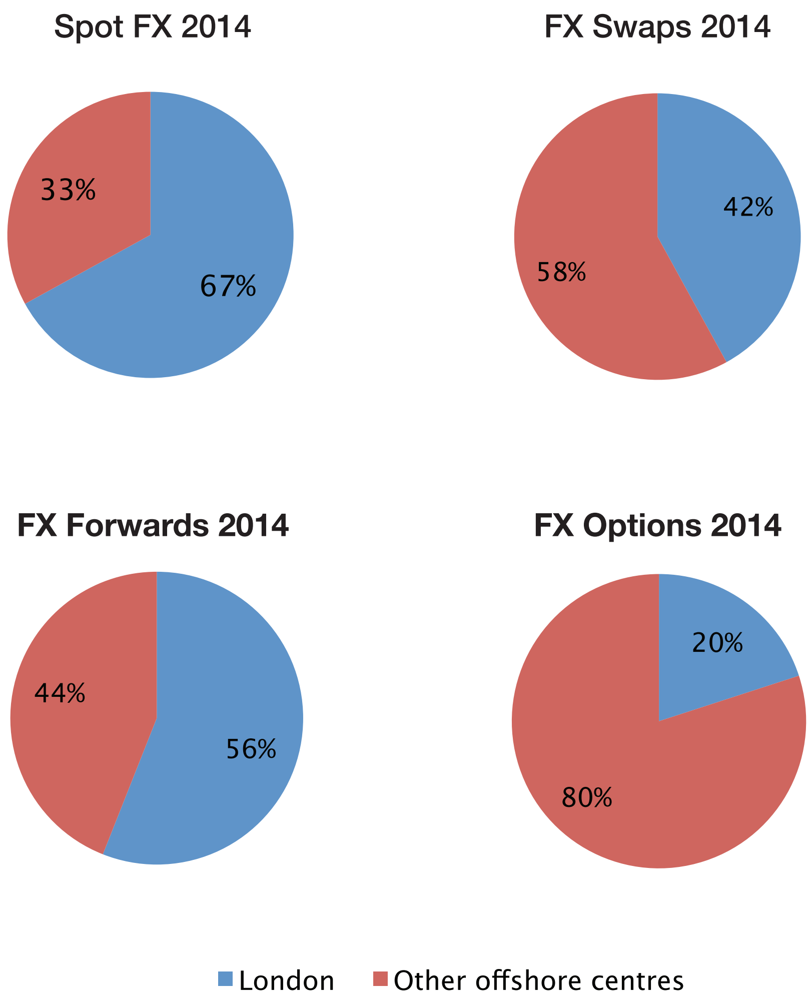
- RMB deposits are sizeable in Hong Kong, Taiwan, and Singapore in particular, but then fall away sharply;
- RMB FX trading volumes are significant in Hong Kong, Singapore and the U.K., but nowhere else; and
- the number of RMB listed bonds is significant in Hong Kong, Singapore, Luxembourg and Taiwan, but then falls away.

This pattern of uneven activity is quite normal in currency markets, and reflects the earlier observation that financial market activity tends to gravitate to where the liquidity and/or expertise is.

A number of centres - including Seoul, Frankfurt and Paris - have a model for developing as RMB centres that starts from increasing local RMB liquidity and turnover on the back of trade invoicing and then builds from this to developing a wider range of liquid RMB products. But what if local retail investors do not hold foreign currency deposits to any significant extent and not many companies choose to invoice in RMB and/or to hold RMB on their balance sheets? If CNH flows between offshore centres are increasing, is local liquidity vital in terms of building up RMB activity?

The best answer to this question would appear to be: yes and no, depending on the type of RMB activity under discussion. London is a major source of RMB foreign exchange business, yet RMB deposits in London are still very small. As noted earlier, the forward deliverable foreign exchange market has become an important source of RMB turnover and liquidity, with hedge funds active in this space. However, it is also worth noting that, according to Bourse Consult surveys of London RMB volumes, a significant proportion of RMB business that is booked by banks to their London trading operations is actually transacted in other centres, in particular Hong Kong and Singapore. According to the most recent survey covering 2014, this was the case for example for around 33% of spot FX transactions and 44% of FX forwards transactions (Figure 1.3).

Figure 1.3: London RMB Deliverable FX Transactions Executed in Other Offshore Centres



Source: City of London and Bourse Consult (2015).

London is a good example of the broader observation that RMB banking business can be transacted in any of the offshore centres, and similarly the trade can be booked to different centres for tax or other reasons. This is as true for large Australian banks as for any other banks: they can offer RMB spot and forward products or trade financing to their local clients, but transactions can be priced and the risk managed in other centres where the liquidity is greater.

Similarly in the funds management space, a fund manager in a particular centre with approval to use part of an RQFII quota can open an RQFII fund denominated in any currency and use the RQFII allocation to obtain CNH from his or her bank, which in turn can obtain the funds from other offshore centres where there is greater liquidity.

In addition, as noted earlier RQFII quotas are themselves becoming quite fungible, so that larger funds management companies with a presence in a range of centres can use their share of a quota obtained in one country, combine it with a share obtained in another country and then manage the fund in a third country, for sale anywhere.

On the other side of the coin - namely, opportunities for Australian fund managers to manage portfolio investment flows coming out of China as capital controls are further relaxed - local RMB liquidity is clearly not relevant. What is relevant is whether the Australian funds management sector has the skill set, investment vehicles and expertise in the right asset classes to attract Chinese investors. This is an important focal point in Part Two.

In other areas of RMB activity, local liquidity would appear to be critical. An example, discussed in detail in Part Two, is capital markets. If an offshore RMB centre has ambitions to become a centre for RMB debt issuance, settlement and secondary trading, as Singapore and Luxembourg have done, then local liquidity would seem to be vital.

One potentially important source of such liquidity could be the funds management sector: if for example there was a growing demand within the sector for RMB-denominated bonds that could both encourage local issuance and also provide the base for secondary market trading and turnover. These issues will be explored in Part Two.

CHAPTER SIX:
Dialogues with China

One of the issues discussed with contacts in other offshore centres was the arrangements that are in place in for ongoing dialogue with China, at both the official and market level, on issues that are of relevance to building up RMB activity. The focus was on what works well and what does not. The objective was to use this information to think about the structures which Australia has in place and whether there is scope for improving them: an issue discussed in Part Two.

In addition to looking at arrangements in other RMB centres for dialogue with China, discussions also focused on domestic arrangements for ongoing dialogue between the market and the official sector on both cross-border and domestic RMB-related policy issues.

All of the offshore RMB centres visited have in place institutional arrangements for ongoing dialogue with China. In most cases, these mechanisms exist at both an official level - involving government ministers and/or market regulators - and at the level of market participants.

In some cases, such as Hong Kong and Singapore, some of these arrangements are longstanding, reflecting close historical relations and co-operation between the two jurisdictions on financial market issues. In others, such as Canada, they are still being put in place.

Because of differences in the historical and cultural links which offshore RMB centres have with mainland China and also differences discussed earlier in the role played by the official sector in promoting and facilitating RMB activity across different centres, the arrangements which some other centres have in place are not really relevant for Australia. One example which is directly relevant is London:

- the nature of the role played by the official sector - government, central bank and regulators - in terms of facilitating financial sector activity is similar in the two countries; and
- in both countries, the structures that have been put in place at both the official and market level for ongoing dialogue about offshore RMB issues are reasonably new, rather than a reflection of longstanding historical and cultural links not applicable to Australia.

Box 1.3 below looks in some detail at the arrangements which the UK has in place for both ongoing dialogue with China on RMB-related issues, and for domestic dialogue within the UK between the official sector and the market sector focused on RMB issues. It also includes feedback from some of the participants in these dialogues. Some of the key points are as follows:

- *If the mechanisms in place for facilitating exchanges of views between the official and market sectors domestically (which can then feed into negotiations with China) are to work well, they require both open and honest exchanges of ideas and also, as far as possible,* *market sector participants taking a "big picture" view of issues and reaching agreed positions;*

- *This can be facilitated by formal bodies for such dialogues and discussion, where the senior financial sector representatives participate in a personal capacity rather than representing their company.*
- *It is also important to have structures in place that provide early feedback from Chinese policymakers and advisers on potential policy proposals.*

These issues are returned to in Part Two of this report.

Box 1.3: Dialogue Between the UK and China on RMB Issues

Dialogue between the UK and China on issues relating to London as an RMB centre takes place at two main levels:

- An annual Economic and Financial Dialogue, led by the Chancellor of the Exchequer and the Chinese Vice Premier. This dialogue, which commenced in 2008, is also attended by the Bank of England, the Prudential Regulation Authority and the Financial Conduct Authority. It focuses on a wide range of financial services and other issues, and hence can extend well beyond London as an RMB centre; and
- Market discussions with China. These occur on a more ad hoc rather than regular basis, when there are topics of mutual interest to discuss. In recent years it has encompassed a conference in China hosted by the Deputy Governor of the People's Bank of China. On the UK side, it has involved industry representatives, international banks with a presence in Hong Kong and mainland China, and HM Treasury and the Bank of England as participants.

Feedback from some of the participants in these dialogues suggests that having both official and private sector channels, with official representation at most of the non-official dialogues, is important for ensuring that information is shared on a regular and consistent basis and that market relevant policy issues are being discussed. As one participant put it: "Making sure industry is kept up to date and consulted regularly is essential to finding out where the practical barriers are and then addressing them".

Domestic Dialogue in the UK on RMB Issues

The main formal mechanism for ongoing dialogue and work on RMB issues in London is the City of London RMB Initiative. This is a private sector initiative, but with active involvement by the official sector as well: it was set up by the City of London with the agreement and support of HM Treasury and industry.

Launched officially in April 2012, the role of the RMB Initiative is to:

- "Provide leadership to the wider financial markets on the technical, infrastructure and regulatory issues relevant to the development of the RMB product market in London;
- Advise HM Treasury on maximising London's capacity to trade, clear and settle RMB and articulate practical next steps and long term aims for the development of the RMB market in London. Additionally, the group advises HM Treasury and other UK authorities on any financial stability concerns the members may perceive; and
- Develop and maintain, as appropriate, a private sector dialogue on the international RMB market with regulators in Hong Kong and mainland China to complement that which is already maintained by the UK public sector." (www.cityoflondon.gov.uk)

The initiative consists firstly of an Experts Advisory Group (EAG), whose work is overseen by the Bank of England. It is composed of senior/middle management representatives of 13 London banks, including 5 Chinese banks. However, private sector attendance is flexible: bank representatives from different areas may attend some meetings depending on the issues on the agenda, and non-members from other financial services companies, such as clearing houses, asset managers, trade associations or law firms, may be invited where an agenda item warrants it. Meetings are also attended by the Bank of England, HM Treasury, the Prudential Regulation Authority and the Financial Conduct Authority. The City of London provides the Secretariat for the RMB Initiative.

A second element is three working groups, whose work largely emanates from the EAG:

- a Clearing and Settlement Working Group;
- a Products and Services Working Group; and
- an Education and Marketing Working Group.

Some members of the EAG are also members of a Working Group: it is left up to the banks to decide who best represents them, and they are encouraged to communicate internally on the issues discussed. The EAG meets monthly, while the working groups typically meet less often.

The RMB Initiative also commissions research designed to support London's development as an RMB centre; publishes an RMB resource pack which provides information on RMB products and services currently available in London; and publishes RMB updates, papers, speeches and media reports emanating from both industry members and the official sector. It publishes a quarterly newsletter highlighting RMB developments in London along with recent work carried out by the initiative. Its website can be seen at *www.cityoflondon.gov.uk.*

Feedback from industry to the official sector on relevant policy issues occurs through the official sector "observers" on the EAG and the working groups.

Discussions with from a number of participants in the Initiative suggest that these arrangements work well. Discussions at both the EAG and in the working groups are typically open and robust, although this is to a fair extent determined by the personalities involved. Allowing flexibility in terms of the attendance at the EAG was seen as an important part of the success of these feedback arrangements.

However, some of the weaknesses of these more formal domestic dialogue mechanisms are:

- they are overly focused on the banking sector, whereas the broader development of RMB-related financial services business in the UK involves other parts of financial services such as funds management; and
- because competing financial institutions are involved, it can sometimes be difficult to generate open and honest discussion and debate.

UK Trade and Investment, The Foreign Office, H.M. Treasury and to a lesser extent the Bank of England also have ongoing but ad hoc and informal discussions with contacts right across the financial services sector, including but not only in the banking sector. These informal discussions, which are mainly overseen by H.M. Treasury, ramp up in the period leading up to the annual Economic and Financial Dialogue, with a view to putting together issues for discussion and negotiation at these dialogues.

One issue of considerable relevance to Australia which has been put onto the Economic and Financial Dialogue agenda following discussions with industry is the maximum 49% limit on funds management financial services joint ventures in China.

A further important element which "squares the circle" of consultations is getting early feedback from government and regulators in China on whether particular policy proposals are realistic and in line with the broad objectives of the Chinese Government. This is done primarily by UK Trade and Investment through its offices across China. They are responsible for keeping in close touch with regulators and government in mainland China, for the purpose of using them as a "sounding board" on policy proposals and also for keeping on top of the latest thinking and developments with respect to further opening up of China's financial markets and RMB internationalisation issues more generally.

CHAPTER SEVEN: Some Issues for Sydney

Some key observations with respect to offshore RMB centres are as follows:

- As with other freely tradeable currencies, once the RMB is internationalised the distribution of RMB transactional business around the world will be largely market determined, with activity tending to gravitate to where there are pools of liquidity and with the Chinese central bank being the ultimate source of global liquidity.
- However, it is likely to take 5-10 years before the RMB is a major international currency, which should be long enough for those financial services companies who wish to do so to establish or enhance an “early mover” advantage.
- RMB flows between offshore centres have picked up significantly, with something of a “hub and spoke” network developing as smaller centres - such as Paris, Sydney or Frankfurt -draw on the larger pools of liquidity in Hong Kong, Singapore or London. Within this framework, success for smaller centres will likely require carving out a “niche” for themselves, based on their own unique characteristics and market strengths. Having sensible policy settings in place in the areas of cross-border taxation and regulation will also be crucial.
- In some areas of offshore RMB activity, such as capital markets, local RMB liquidity may be critical. In other areas however, such as transactional banking business or funds management, local RMB business can build up based in part on drawing liquidity from other centres.
- Arrangements at both an official and a market level for ongoing dialogue and discussion with China on RMB-related issues are important for developing trust between both market participants and officials and for discussing relevant policy issues. Having both official and private sector channels, with official representation at most of the non-official dialogues, is important for ensuring that information is shared on a regular and consistent basis, and that relevant policy issues are being discussed with a view to finding solutions.
- Many offshore centres also have arrangements in place for ongoing domestic dialogue between the market and the official sector on RMB issues. If policy issues are to be addressed in a meaningful manner, having well functioning feedback mechanisms from the market sector to the official sector is critical.

These observations in turn highlight a range of issues that are explored in Part Two of this research report with respect to developing Sydney as an RMB centre, in particular the following:

- Is it realistic to imagine that Sydney can build up substantial local RMB liquidity over coming years?
- If Sydney is unlikely to become a significant source of offshore RMB liquidity, which potential areas of RMB activity - transactional banking, capital markets, funds management - are likely to be most affected?
- What are the potential links between the funds management sector and capital markets when it comes to building local RMB business?
- Taking into account discussions with industry on the previous three issues, what are the areas where, even in the possible absence of significant local liquidity, Sydney is best positioned to carve out a niche as an offshore RMB hub?
- Does the Australian funds management sector have the requisite skills, investment vehicles and expertise in the right asset classes to attract portfolio investment flows coming out of China as capital controls are further relaxed?
- Are there any policy obstacles, at the state or federal level, that are likely to inhibit development of RMB activity in Sydney? Do we have in place effective mechanisms for identifying and dealing with hem?
- Are there any market constraints?
- Do we have in place the best mechanisms, at both an official and a market level, for discussions and negotiations with China on financial services market access and related policy issues?
    - Do we have in place the best mechanisms for domestic interaction between the official and market sectors on these issues?
    - Do we have mechanisms for getting early feedback from Chinese policymakers and advisers on possible policy proposals?

APPENDIX 1.1:
Shanghai Free Trade Zone

The Shanghai Free Trade Zone (SFTZ) was established in September 2013 with two principal objectives - to speed up domestic reforms, and to act as a testing ground for financial liberalisation. Regulation in the zone is based on a 'negative list' [19] where for all industries not listed, foreign investors will receive equal treatment to domestic companies, including importantly by way of a simpler and faster "registration" rather than "approval" process. Pilot programs that are successfully tested in the zone are likely to be rolled out on a national level.

The SFTZ is a dynamic pilot project, in the sense that the regulations on what can or cannot be done in the zone are evolving over time. Many financial services companies with a presence in the SFTZ set up there in the expectation that, going forward, the range of activities they can engage in and the links between the SFTZ and the rest of mainland China will expand and evolve over time.

One important financial reform in the SFTZ is fewer restrictions on cross-border RMB sweeping than applies in the rest of mainland China. This allows companies to more easily sweep cash from their onshore operations and repatriate back to their offshore operations.[20] This ability to move working capital more freely in and out of the SFTZ is important for companies that previously had earnings trapped in their China operations. Financial institutions within the zone can also access potentially cheaper offshore funding and, subject to certain restrictions, utilise it within the SFTZ.

As noted above, the streamlining of applications is a further innovation, with the SFTZ now offering a 'one stop shop' process for foreign investments. This is in contrast to the system outside the zone that often requires co-ordination of several regulatory agencies.

The SFTZ has a separate arbitration process administered by the Shanghai International Arbitration Centre (SHIAC)[21]. The rules are more closely aligned with international standards and therefore allow for more certainty in dispute resolution. In addition, this process can be applied to non-FTZ related cases if both parties agree to abide by the rules.

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19 A revised negative list was released in April 2015 for implementation in May 2015. For a discussion see China Briefing (2015)

20 Treasurytoday (2014)

21 China Briefing (2014)

The zone has been expanded to 120 square km and now takes in the Lujiazui financial district.

For some industries, the costs of setting up in the SFTZ can be significant. For example, there are at present strict rules requiring banks to establish a firewall between zone activities and the rest of mainland China. As a consequence, foreign banks face high start-up costs in the zone due to the need to split their ledger. This independent accounting system for the zone branches can add up to $10million to the start-up costs for each bank branch in the SFTZ [22].

22 Yu (2015)

PART TWO:

SYDNEY AS AN OFFSHORE RMB CENTRE: CARVING OUT A NICHE

CHAPTER ONE: The Potential Gains

Finance Follows Trade

The Chinese economy is in a period of transition from a very rapidly expanding, energy intensive, investment and export-led growth model to a somewhat slower, less energy intensive, consumption-led growth model. This is being both policy and market driven: as China's wealth continues to grow and its middle class expands, so does the demand for a cleaner environment and for a wider range of consumer goods and services, including financial services.

Data and studies on the rapid growth in income and wealth in China and the associated rise in demand for services are widespread[23]. Among the salient features worth briefly mentioning are the following:

- The service sector is already an important driver of the Chinese economy, accounting for 48% of China's economic output in 2014 (Figure 2.1(a)); [24] and
- China's upper middle class (defined as people with annual disposable income between US$16,000 to US$34,000 a year) is forecast to grow from 14% of urban households in 2012 to 54% percent in 2022, and with it the importance of the service sector in the Chinese economy (Figure 2.1 (b)).[25]

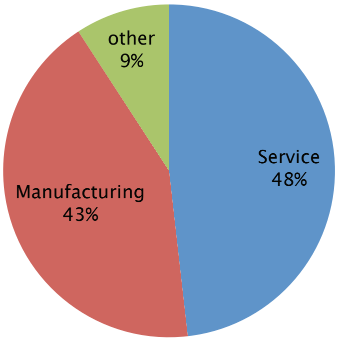
23 See for example Barton et al (2013) and Ernst and Young (2014)

24 KPMG (2015)

25 Barton et al (2013)

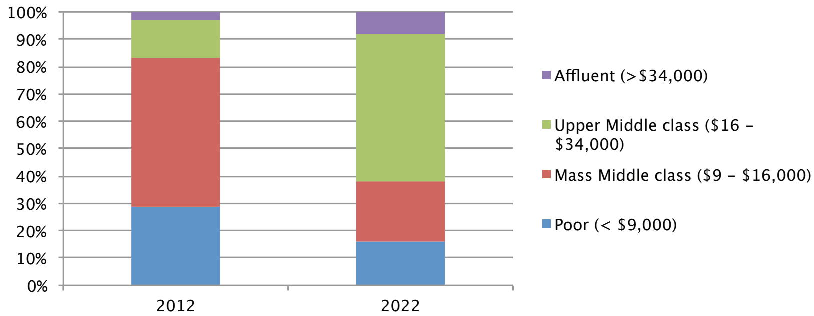
Figure 2.1: Distribution of Chinese Economic Output and Urban Income

(a) China's economic output by industry, 2014



Source: CEIC, KPMG (2015)

(b) Share of urban households in China



Note: data for 2022 are projected and values are in US dollars.
Source: McKinsey Global Institute (2013)

Australia has benefited greatly from the phase of rapid, energy-intensive, export-oriented growth, both by way of our exports of commodities to China and our importing a wide range of manufactured goods produced and sold much more cheaply than we can produce or sell them. On the flip side, China has benefited from having a reliable, low cost source for the commodities it has needed to drive growth, and a market for selling a wide range of its exports into.

The political and economic challenge for Australia as it observes China's transition to less energy intensive consumption-led growth is how to broaden and deepen our trade relations in a way which continues to be of benefit to both countries. How can governments and private enterprise best work together to establish a broader economic partnership between our two countries? Or, to ask the same question in a somewhat more direct manner: what do we have that China needs, and what does China have that we need?

The answers to these questions are wide-ranging, including on one side Australia's expertise in health care, education, agribusiness, financial services and energy; and on the other side Australia's ongoing requirement for imported capital to fund our investment needs.

The focus of this report is on both sides of this equation but in just one sector, namely financial services. In this sector more than most, the changes underway in China are a function of not just economic developments but also dramatic policy changes. One dimension is the growing demand by China's burgeoning middle class and rapidly expanding private sector for the full range of financial services, including capital markets to help finance economic growth and development; asset management and insurance products to grow and protect private wealth; and retirement income schemes. But equally important is China's commitment to RMB internationalisation and the associated opening up of its financial markets to the rest of the world.

When these factors are considered together, the potential opportunities for the Australian financial sector are obvious. An earlier report by the authors discussed at length the prospective growth rates in China's capital markets, which are already among the largest in the world; China's pervasive global trade links, which will provide growing opportunities for RMB-denominated transactional banking business and products; and the huge savings pools in both the private and official sectors in China which will increasingly need to be diversified into offshore assets, providing opportunities for offshore fund managers [26].

The underlying theme in the author's earlier research report was that, historically, finance follows trade: "As trade linkages increase, firms require an increasing array of financial services. And a strong trading relationship helps businesses in both countries identify and develop investment opportunities in the other." [27] *While to date China's financial links with the rest of the world have been extremely limited relative to its trade links, as China relaxes its capital controls and opens up its capital account these financial links will grow very strongly and over time will match China's trade links and the size of its economy.*

Australia needs to ensure it is well positioned to take advantage of these prospective seismic shifts in global financial flows.

How Large Are The Potential Gains?

How large are the potential opportunities to Sydney, and Australia more broadly, flowing from the combination of China's substantial trading links with us, the growing need for sophisticated financial services in China and the opening up of China's capital account?

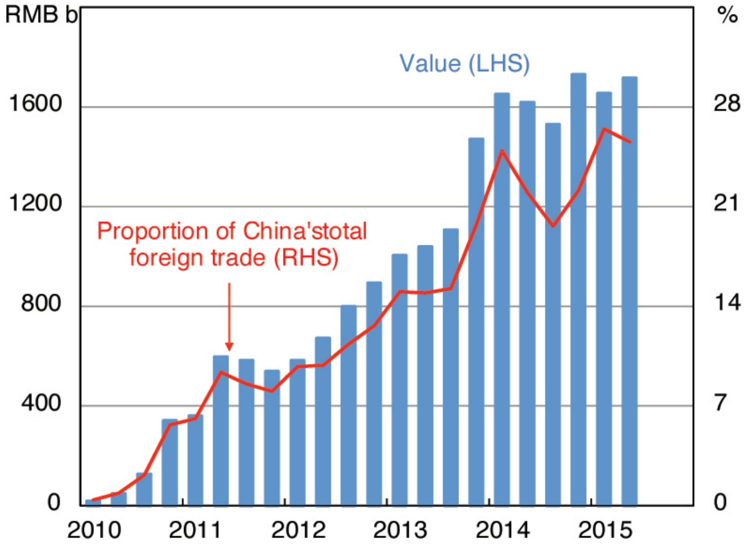
The use of onshore RMB (CNY) in cross border trade-related foreign exchange transactions has been gradually liberalised since 2009. Associated with this has been a rapid increase in the proportion of Chinas' trade that is settled in RMB, from 0% in 2009 to around 26% in the second quarter of 2015 (Figure 2.2). Some market projections suggest that RMB trade settlement could reach up to 50% of China's total trade by 2020[28].

26 Eichengreen, Walsh and Weir (2014)

27 Lowe (2013)

28 See for example HSBC (2015)

Figure 2.2: Renminbi Trade Settlement



Source: CEIC Data

Largely reflecting this increase in RMB trade invoicing, global transactional volumes in RMB have risen dramatically. SWIFT data suggest that, in terms of ranking as a global payment currency, RMB volumes have risen from eleventh in June 2013 to fourth in August 2015, marginally in front of the Japanese Yen.[29]

Australian banks are focused on providing the full range of services to companies trading with China, including foreign exchange, derivatives products for hedging, trade financing and RMB banking facilities. The major Australian banks are also focused on Australian companies looking to invest in China, and providing assistance to Chinese companies looking to invest directly in Australia. Chinese banks with a presence in Australia are also looking to assist Chinese companies investing here. Such investments are likely to show rapid growth over coming years, as discussed in Chapter Three below.

A recent CBA project with modelling support from Boston Consulting Group[30] looked at likely revenue growth for financial services companies over the next 5 years via China related business, including transactional banking business, lending, commodities, retail banking, debt capital markets and wealth management. Based on a set of conservative assumptions[31] with respect to the underlying parameters, the scenario analysis suggests that gross revenues flowing from

29 Source: SWIFT (2015). SWIFT data need to be interpreted cautiously: see Chapter Eight.

30 Boston Consulting Group (2015).

31 By way of example, the analysis assumes 6% average annual growth rate of China's economy over this period; 6% average annual growth in Australian exports to China; 10% average annual growth in Chinese foreign direct investment in Australia; and growth in the proportion of Australia's commodity trade that is invoiced in RMB from less than 1% to around 6% by 2020. The last assumption would appear to be particularly conservative: see Chapter Four.

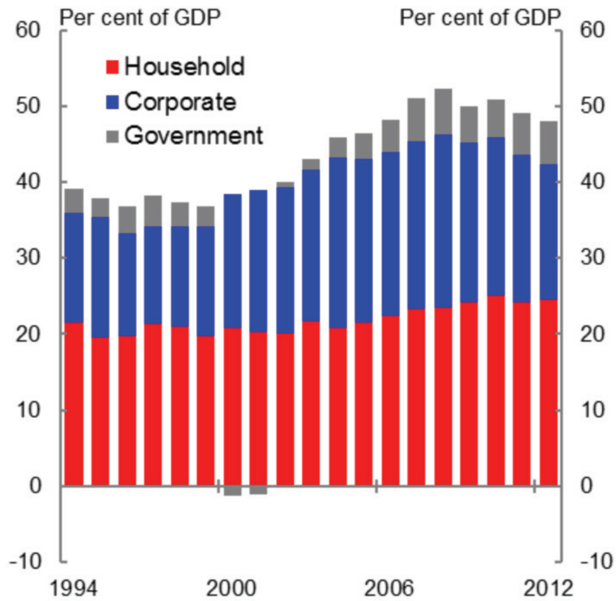
China/Australia trade, direct investment and portfolio flows and related activities could increase from $A 3.8 billion in the base year of 2015 to A$ 5.7 billion in 2020.

Putting these various factors together:

There is substantial scope for Australian banks and also overseas banks with a presence in Australia to build up RMB-related banking business. This is particularly true once account is taken of the likely move over coming years to RMB settlement of many of Australia's commodity exports to China, a point discussed in detail in Chapter Four.

The authors' earlier report on internationalisation of the RMB noted that one of the key characteristics of the Chinese economy was its enormous and growing pool of domestic savings, held in all three sectors of the economy - corporate, government and household (Figure 2.3 below). The earlier report also noted that, looking forward, a variety of factors may see the rate of growth of some of these savings pools slow. Nonetheless, China is likely to maintain one of the largest global pools of national savings.

Figure 2.3: Sectoral Savings in China



Source: CEIC (latest available data)

Increasingly, in the interests of optimal portfolio management and risk diversification, these savings pools need to be and are being invested in overseas assets as well as domestic assets. Much of this overseas investment will be managed domestically, by local mutual funds and other investment managers; but some of it will be and is being contracted out to external managers or through joint ventures with overseas asset managers. As capital controls are increasingly relaxed, this process is likely to continue.

Looking at the potential benefits to the Australian economy from managing even a small fraction of these extremely large savings pools in China, a May 2014 study by Deloitte Access Economics that was commissioned by the Financial Services Council estimated that flows of offshore sourced investment funds into Australian domiciled funds management vehicles contributed around $0.4 billion in total value added to the Australia economy in 2012-13[32].

The Deloitte Access Economics modelling work suggested that a doubling of offshore funds under management would add around $325 million to GDP, over $100 million to tax revenue and over 750 jobs to the Australian economy. This is a very unambitious target: a 2014 survey suggested offshore sourced funds more than doubled in the four years to end 2013[33]; the pace of policy change in China providing increasing opportunities for offshore fund managers is accelerating; recent domestic policy changes, in particular introduction earlier this year of an Investment Manager Regime, should facilitate greater inflows going forward; and a further doubling would still leave Australia substantially below many other financial centres in terms of the proportion of funds under management that are sourced offshore[34].

Given on the one hand the fact that only a very small percentage of total managed funds in Australia are currently sourced offshore, and on the other hand the enormous savings pools in China that need to be diversified into offshore investments, it is clear that, over time, the potential contribution to the Australian economy from managing more investable funds sourced in China is substantial.

Realising Potential Opportunities

Identifying the very large potential opportunities available to Australia from RMB internationalisation is one thing. Realising those opportunities is another. It requires a wide range of factors to be in place. Amongst the key requirements are the following:

- An open, efficient, dynamic and well-regulated financial sector that is recognised as such offshore;
- A financial centre that has the necessary infrastructure and facilities in place and is an attractive place to work and do business;
- A business culture that is looking for offshore opportunities to grow;
- Identification of areas in which Australia's financial sector has a comparative advantage;
- An understanding of Chinese culture and ways of doing business, including how financial products are distributed and how its regulatory system works and its regulators think;

32 Deloitte Access Economics (2014) page i.

33 Source FSC/Perpetual (2014)

34 op. cit., page. i.

- A financial services taxation and regulatory framework which provides stability and certainty and does not place unnecessary obstacles in the path of overseas opportunities;
- A willingness to negotiate openly with China on market access and related issues, which requires identifying clearly both realistic policy changes that China would like to see in Australia and changes that the Australian financial services sector would like to see in China; and , in order to achieve this; and
- Effective co-ordination between the Australian financial services sector and the official sector on policy issues relating to China/Australia financial relations.

The remainder of Part Two examines these requirements and how well our financial markets and policy settings are placed to meet them.

CHAPTER TWO:
What Does Sydney Have to Offer?

(a) Sydney as a Financial Centre

NSW has Australia's largest financial services sector, contributing $A56 billion or 12% of Gross State Product in 2012-13. Almost 40% of workers in Sydney's CBD are employed in the sector. Sydney is the headquarters for 53 of the 64 banks that operate in Australia, along with the key financial regulatory bodies and the Australian stock exchange[35].

How does Sydney rank as a financial centre compared to other financial centres in the region and beyond? What does it have to offer?

This issue was examined in detail in a 2009 report to the Federal Government by the Australian Financial Centre Forum (the Johnson Report).[36] The report argued that two key features of leading, sustainable financial centres were:

- a full-service, efficient, competitive and well-regulated domestic financial centre; and
- a high degree of cross-border financial activity transacted through the centre.

The report argued that cross-border transactions are the likely and desirable consequence of a financial sector that is open, competitive, efficient, and where there are no major policy constraints to 'trading' in financial services with other countries. In other words, if we are good at financial services then – as is the case for example with education services, mining or agriculture – we should be making full use of that comparative advantage by exporting our skills and services.

The report suggested that Sydney ranked highly on the first criterion above: that is, being a full-service, efficient, competitive and well regulated domestic financial centre. It based this assessment on, amongst other factors:

- a wide range of international surveys of financial centres that generally ranked Australia quite highly, especially on such criteria as political stability; the breadth of products available; the quality of its education system and human capital; and the quality of corporate governance and regulation; and
- the observation, at the height of the global financial crisis, that: "The high credit rating and strong capitalisation of our major banks, in an environment where counterparty risk has become a heightened concern to financial market participants, has already resulted

35 Source: http://www.industry.nsw.gov.au/invest-in-nsw/about-nsw/economic-growth/indsutry-structure viewed 1 October 2014.

36 Australian Financial Centre Forum (2009)

in an increase in business for them in the region. The reputation of our regulatory system has been significantly enhanced around the world"[37].

However, on the second criterion used to rank Sydney as a financial centre - that is, the volume of cross-border activity transacted through the centre - it ranked much lower. The report based this assessment on a number of factors:

- A 2009 consultant's report[38] which categorised some 33 financial centres and ranked Sydney very highly in terms of "full service" provision but middle of the pack in terms of degree of cross-border activity;
- the Forum's own analysis showing that Australian financial services exports relative to the overall size of the sector were small compared to other countries; and
- the observation that, while Australia has a large, efficient and competitive funds management sector, the proportion of funds sourced offshore was very small.

Developments and analyses since this report was completed would not appear to have changed this broad assessment, although they have added some nuances. On the first criteria mentioned earlier, the July 2014 Financial System Inquiry Interim Report noted the following:

"Globally published indices are regularly released comparing various national attributes, including 'competitiveness'. Australia is generally ranked highly for liveability, strong rule of law, financial market sophistication, lack of corruption and overall economic environment. However Australia is typically ranked lower on the overall burden of regulation and business focus of regulators."[39]

On the second criterion of a high level of cross-border flows, the Interim Report observed that, while elements of Australia's financial system are internationally integrated, exports of financial services to other markets are limited. It went on to state that: "Financial system developments in the region will require continuing Government engagement to facilitate integration with Asia."[40]

On the funds management side, the latest Australian Bureau of Statistics (ABS) data suggest that the proportion of total funds under management in Australia that was sourced offshore is still around 3.5%, as it was at the time the Johnson Report was written.[41] That compares for example with 40% of funds managed in the UK or 65% in Hong Kong.[42] However, given the rapid growth in total funds under management in Australia due in large part to our compulsory superannuation system, this unchanged percentage represents a significant increase in the absolute value of funds sourced from offshore (Figure 2.4).

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37 Op. cit., p. 11.

38 Oliver Wyman (2009.)

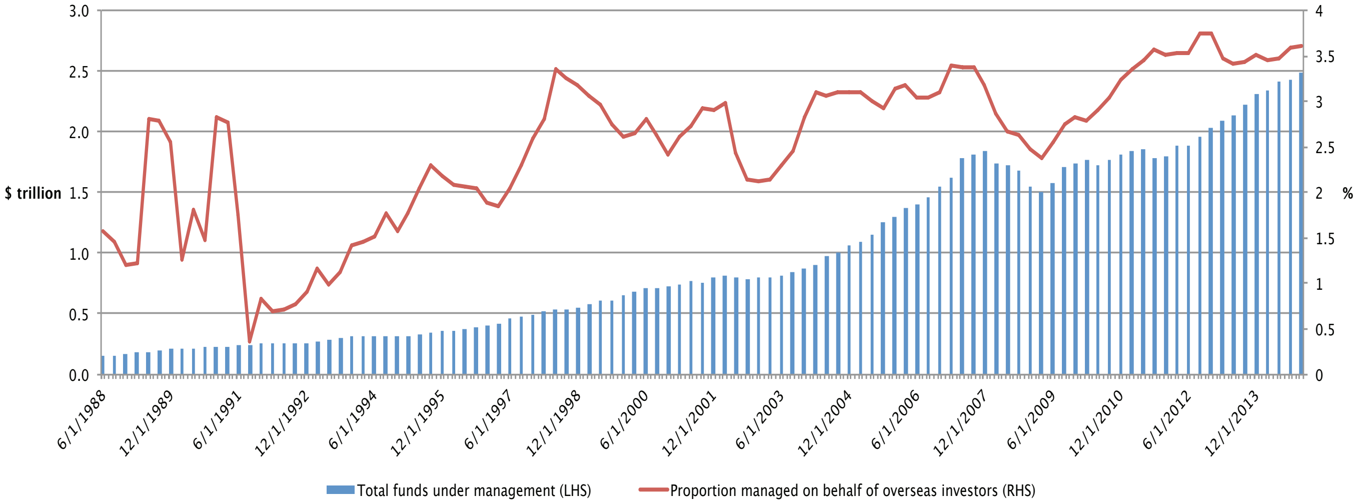
39 Financial System Inquiry (2014) p. 4-81.

40 Op. cit., p. 1-10.

41 Source: Australian Bureau of Statistics, "Managed Funds Australia", 5655.0, March Quarter 2015.

42 See Financial Services Council (2014) Chapter 4.

Figure 2.4: Proportion of Funds under Management in Australia Managed on Behalf of Overseas Investors



Source: Australian Centre for Financial Studies (2015), Figure 22

A recent report on financial integration in the Asia-Pacific made some interesting and relevant observations concerning Australia's cross-border financial services business. It argued that a major limitation of financial services exports data is that they do not cover services provided by an Australian commercial presence abroad. Using a number of surveys of foreign affiliate activities of companies in the finance and insurance sector, along with estimates for other sectors given that data on foreign affiliate sales are not available for other sectors of the economy beyond 2009, the study concluded that, based on a broad definition of exports so as to include foreign affiliate sales:

"The Australian financial services industry itself is a major exporter - of a magnitude not often understood in the community. Analysis in this report suggests that the total annual value of financial services exports, including sales by Australian-owned affiliates or subsidiaries overseas, may have reached $55 billion in 2013. This is equivalent to about 17% of all exports of goods and services, larger than tourism exports and more than double the value of education exports. As in the case of investment, however, more than 70% of Australian financial services exports are oriented towards the United States, United Kingdom and New Zealand."[43]

A breakdown of the foreign affiliate sales data suggests that funds management services are a small proportion of the total, with categories such as insurance much larger.

This interesting work on financial services exports broadly defined raises some pertinent issues:

43 Australian Centre for Financial Studies (2015) p. 5.

One of the themes emphasised in this report is that, in many areas, doing financial services business with China requires a presence on the ground in China. This is often necessary both in order to better understand and build up a relationship with Chinese regulators and also for brand recognition and distribution reasons.

Does this mean that the direct benefits to Australia, in terms of local jobs, skills and tax revenue, are lost? Recent research emanating from the U.S. in particular emphasises the benefits to home economies from offshore foreign investment and associated foreign sales and business. By way of example, a 2013 study found that:

"Expanded activity at foreign affiliates of US corporations is associated with more production, greater employment, higher exports and more research and development in the United States."[44]

The study suggested that, on average, a 10% increase in offshore employment by the foreign affiliate of a US company led to a 4% increase in employment by the same firm in the US.[45]

Sydney is not only a dominant city for financial services but it is also the centre of Australia's information communication technology (ICT) industry and home to the highest number of technology start-ups in Australia[46]. The intersection of these industries and the financial sector widely referred to as fintech, is experiencing rapid growth globally.

The strength of the financial services and ICT industries in Sydney made it an obvious place to establish fintech centres. By way of example, Stone & Chalk, an independent, not-for-profit Fintech hub, was established in Sydney in 2015 with the objective of helping to foster and accelerate the development of world-leading fintech start-ups.

Another key Sydney initiative is the establishment of the 22-hectare Barangaroo site, which is likely over coming years to become the local or regional headquarters for many Australian and overseas financial services companies, reinforcing Sydney's position as a key financial centre in the Asia Pacific region.

(b) Sydney as an RMB Hub

The above section looked at what Sydney has to offer as a full-service financial centre. What does it have to offer more specifically as an RMB centre?

As was noted in Part One of this report, in line with most of the financial centres that have been nominated by China as "official" offshore RMB centres Australia now has:

44 Hufbauer et al (2013) Executive Summary. This finding is consistent with other studies including Desai Foley and Hines (2009) and McKinsey Global Institute (2003).

45 op. cit., Executive Summary

46 http://www.industry.nsw.gov.au/business-and-industry-in-nsw/key-industry-sectors/information-and-communication-technology viewed 1 October 2015.

- An official RMB clearing bank;
- A swap facility between the Reserve Bank of Australia and the People's Bank of China; and
- An RMB 50 billion RQFII quota.

These are all very positive developments. However, as discussed in Part One, they will not of themselves automatically result in strong growth in RMB activity; nor do they of themselves give us a competitive advantage over other official RMB centres.

One major development that has occurred recently is the signing of the China-Australia Free Trade Agreement (ChAFTA) in June 2015. Assuming it is ratified by Parliament, this landmark agreement has the capacity to boost trade between the two countries and hence economic growth over coming decades. ChAFTA should encourage further direct Chinese investment flows into Australia as a result of the increase in the general Foreign Investment Review Board approval threshold from $A 252 million to $A 1,064 million. More specifically in the area of financial services, ChAFTA amongst other things [47]:

- Provides increased market access for Australian banks, insurers, fund managers and securities companies;
- Streamlines licence applications across a range of financial services areas for Australian companies in China;
- Encourages Australian private equity investment in China;
- Commits the Australian Securities and Investment Commission (ASIC) and the China Securities Regulatory Commission to strengthening co-operation and improving mutual understanding of each other's regulatory frameworks; and
- Under the Most Favoured Nation commitments in the Agreement, extends any future more preferential treatment for securities firms from other countries to Australian firms, and provides for consultation to consider requests for equal treatment if more preferential treatment is given to other countries in other sectors.

An important aspect of ChAFTA in the financial services area is the establishment of a Financial Services Committee (FSC), providing for engagement between Chinese and Australian financial regulators and officials on issues of mutual interest and allowing issues arising in the bilateral financial services relationship to be addressed. The FSC provides scope for not only discussing issues arising under ChAFTA but, over time, for discussion of further market opening measures of mutual benefit. The potential importance of the Department of Foreign Affairs and Trade is returned to in Chapter Seven.

47 For more detail on ChAFTA and the financial services sector, see Department of Foreign Affairs and Trade (2015).

Australia also has direct trading between the AUD and the RMB in mainland China, with two Australian banks being licensed to trade directly onshore in the AUD/CNY cross. At the time of the authors' first report, only three currencies were directly traded in China against the RMB; direct trading now applies to USD, HKD, JPY, EUR, GBP, SGD, AUD, NZD, CAD, CNY, RUB and THB.

More broadly, what Australia has to offer with respect to building stronger and deeper financial flows between the two countries is something more fundamental than the above more specific factors. It is the complementarities in the structure of the two economies. When these complementarities are looked at together, it is clear that Australia - and Sydney in particular as Australia's financial capital - are well placed to build deeper and broader financial relations with China, based on mutual respect and mutual benefit.

Box 2.1 sets out some of the key complementarities.

Box 2.1: Structural Complementarities Between the Chinese and Australian Economies

- Australia is a capital importer while China is a capital exporter and will over coming years become a major one. That in itself provides an important basis for both direct and portfolio flows between the two countries.
- Strongly reinforcing this first point, Australia is rich in energy resources and agriculture, two areas where China has a strong commitment to improving the security of its supplies.
- China is easily Australia's largest trading partner, while Australia is a larger supplier of Chinese merchandise imports than the major offshore RMB centres of Hong Kong, Singapore or the UK. This will over time prove a key element in building closer financial as well as trade relations between the two countries.
- China is progressing down a path of opening up its capital markets, reforming and improving the regulatory structure of its financial sector, fully deregulating its interest rates and moving to a floating currency. It also has a strong need to diversify corporate funding away from over-reliance on bank financing towards more capital market funding. These are all reforms which Australia went through in the recent past, while our regulatory structures were shown to be world class through the global financial crisis. We may also have the advantage, from China's eyes, that we do not carry some of the historical and geopolitical 'baggage" that other countries carry. There is considerable scope for constructive communication and, where sought, assistance for China at both an official and market level as it continues to engage on the pathway to RMB internationalisation.

- As noted earlier, China has very large and rapidly growing savings pools in both the official and the private sectors, which increasingly will need to be invested in offshore assets. Australia has a very large, efficient and sophisticated funds management sector, with the capacity to work with Chinese companies to provide technical assistance and advice on many aspects of funds management and to manage some of China's offshore portfolio investments.
- Australia, through its superannuation system, also has a very large and growing savings pool which will increasingly need to be invested offshore. Being on some measures, already the largest global economy with amongst the strongest global growth prospects going forward, China will over time become an increasingly important component of Australian funds management portfolios.

However, fully realising opportunities for broader financial relations with China will not come automatically or indeed easily. Part One of this report stressed the point that Sydney, as an "official" offshore RMB centre, is in competition with a rapidly growing number of other official offshore centres, some of them considerably larger and more established than we are; and that we need to focus on areas in which we have some comparative advantage and capacity to carve out a "niche". In addition, there are a number of domestic policy constraints in relation to undertaking financial services business with China that need to be overcome.

The following chapters of this report drill down in more detail to examine both these opportunities and constraints.

CHAPTER THREE:
Direct Investment

As noted above, one of the most important complementarities between Australia and China is that, while China has one of the largest net savings pools in the world and the Chinese Government is actively encouraging offshore direct investment, Australia is a capital importer. That observation is central as background to developing Sydney as an RMB hub, for a number of reasons.

Firstly, as discussed in Chapter Four below, one of the main areas of business focus for Australian banks with respect to China is providing assistance, advice and products to Australian companies looking to invest in China and Chinese companies investing in Australia. Maximising these business opportunities often requires a physical presence – that is, direct investment - in mainland China.

Secondly, and as discussed further in Chapter Five, a number of sectors in China with large savings and a need to diversify offshore, such as the insurance sector, have displayed a strong preference for direct as against portfolio investment. Chapter Five also notes that a number of financial services companies are setting up business models focused on helping large institutional investors in China find the right assets in Australia, and in some cases managing a portfolio of assets for them.

Thirdly, one of the themes in Chapter Five is that, for funds management companies looking to build closer financial relations with China, a central requirement is often a physical presence within China.

Fourthly, Chapter Seven below notes the importance of being willing to negotiate with China in good faith on ongoing market access and related issues. Facilitating direct Australian investment in China should be a part of these ongoing negotiations between the two countries on market access in financial services. On the other side of the coin, the Chinese Government is actively encouraging offshore direct investment by Chinese companies, which is increasingly an important policy objective. Facilitating such direct investment was a key focus for China in the negotiations leading up to the China-Australia Free Trade Agreement, which resulted in Australia raising the general threshold for needing FIRB approval for private, non-state owned investment from $248 million to $A 1.08 billion. Australia should be open to negotiation on further measures that may facilitate direct Chinese investment in Australia.

Fifthly, increased Chinese investment in Australia can also add to RMB liquidity here. Increasingly, offshore Chinese direct investment is being conducted in RMB. A recent IMF report suggested that, in 2014, close to 30% of Chinese foreign direct investment was settled in RMB and that “RMB is rapidly advancing as the currency of choice for settling direct investment payments in both directions"[48]. In addition Chinese companies in Australia are more likely to hold RMB balances on their books. As more Chinese companies establish a presence in Australia so the scope for building up RMB capital raisings in Australia also increases, a prospect discussed in Chapter Six.

More generally, given Australia's reliance on imported capital to finance its investment needs, foreign investment flows from China are vitally important for Australia. This is certainly true for NSW, which is by far the biggest recipient of Chinese direct investment (see below) and has put a considerable effort into encouraging and facilitating such investment. NSW has substantial capital needs in a number of areas, including its large infrastructure programs. Over the coming four years, its forward estimates suggests capital expenditure commitments of $A 68.5 billion.[49] The downturn in China's construction sector has seen many large Chinese construction companies turn to overseas for contracts. China Merchants Group's co-investment with Hastings Funds Management in a 99 year lease rights to the Port of Newcastle and its broader strategic partnership with them to identify further infrastructure development projects is an interesting recent example of the broader mutually beneficial opportunities.

While there is no evidence from foreign investment approvals data of any discrimination against China, the authors' earlier report discussed perceptions within China of such discrimination, which are clear from survey data.[50] Some of the recent public debate regarding the ChAFTA has no doubt added to such perceptions. Every effort, at both an official and market level, should be made to emphasise to China that investment in Australia is welcome and indeed is mutually beneficial.

Against the background of the above comments, the remainder of this section looks briefly at Chinese direct investment in Australia and Australian direct investment in China.

(a) Chinese Direct Investment in Australia

In recent years, the Chinese Government has moved to a policy of actively encouraging Chinese companies to invest abroad. These efforts can be seen in the regulatory changes that the National Development and Reform Commission and the Ministry of Commerce put in place in 2014 to relax the approval requirements for Chinese outbound investments. The success of the policy is reflected in the fact that in 2014, for the first time, Chinese overseas direct investment exceeded inward foreign direct investment.

48 IMF (2015) p. 49.

49 NSW Government (2015).

50 Eichengreen, Walsh and Weir (2014), pp. 66-67.

In 2014 the Chinese Government also announced several national strategic initiatives that may lead to significant new offshore direct investment flows in the infrastructure space. The "One Belt, One Road' strategy, the Silk Road Fund and the establishment of the Asian Infrastructure Investment Bank (AIIB) are all likely to promote large-scale infrastructure investment in the countries and regions along the 'belt' and 'road' for at least the next 5-10 years. [51]

The authors' first report on RMB internationalisation looked in some detail at Chinese direct investment in Australia. The key observations in that analysis were as follows:

- Chinese direct investment in Australia has been growing very rapidly in recent years, albeit from a small base: foreign investment levels in Australia, unlike our trade links, are still dominated by Australia's traditional trading partners, in particular the US and the UK;
- As "finance follows trade", the depth and breadth of direct investment flows between Australia and China are likely to increase substantially over time;
- most of the direct investment flows into Australia have gone into the mining and resources sector; and
- The number of Chinese companies listed on exchanges in Australia remains small.

More recent data tell a similar picture, but with some interesting shifts. Chinese overseas investment has continued to grow strongly, with the active encouragement of the Chinese Government. In addition - and reflecting one of the themes of this paper, notably the changing patterns of Chinese demand as incomes and wealth rise - the pattern of offshore Chinese investment continues to broaden beyond resources to such sectors as high technology, food, agriculture, real estate and services. A May 2015 survey on Chinese investment in Australia[52] highlighted amongst other things the following points:

- Chinese investment in Australia's mining and energy sector fell in 2014;
- Nonetheless, Australia was still the second largest recipient of Chinese investment in 2014, having been the largest recipient in 2013. Over the period 2007 to 2014, Australia was the second largest recipient of Chinese direct investment, behind the US;
- ABS data suggest that in 2014 China ranks as Australia's fifth largest investor by stock of foreign direct investment with 4% of the investment stock, behind the US (24%), UK (13%), Japan (10%) and Netherlands (6%)[53];
- NSW attracted 72% of Chinese investment flows into Australia in 2014;

51 "One Belt, One Road", is an economic development initiative for greater trade and investment integration. It incorporates the Silk Road Economic Belt, which will link China with Europe through Central and Western Asia, and the 21st Century Maritime Silk Route Economic Belt, which will connect China with Southeast Asian countries, Africa and Europe. The AIIB is focused on supporting infrastructure construction in the Asia-Pacific region.

52 KPMG and University of Sydney (2015).

53 Source: ABS (5352.0) " International Investment Position, Australia: Supplementary Statistics", 2014.

- For the first time, nearly half of Chinese investment in Australia last year was in commercial real estate. Investment in infrastructure and leisure also exceeded mining investment; and
- There has been a significant change in the type of institutions investing in Australia. For the first time, Chinese private investment last year exceeded that of state owned enterprises, both in terms of number of deals and their total value.

Since the above survey was completed, China Investment Corporation (CIC), China's primary sovereign wealth fund, invested $A 2.5 billion in a portfolio of office buildings sold by Investa Property Group. This represented Australia's largest direct office sale.

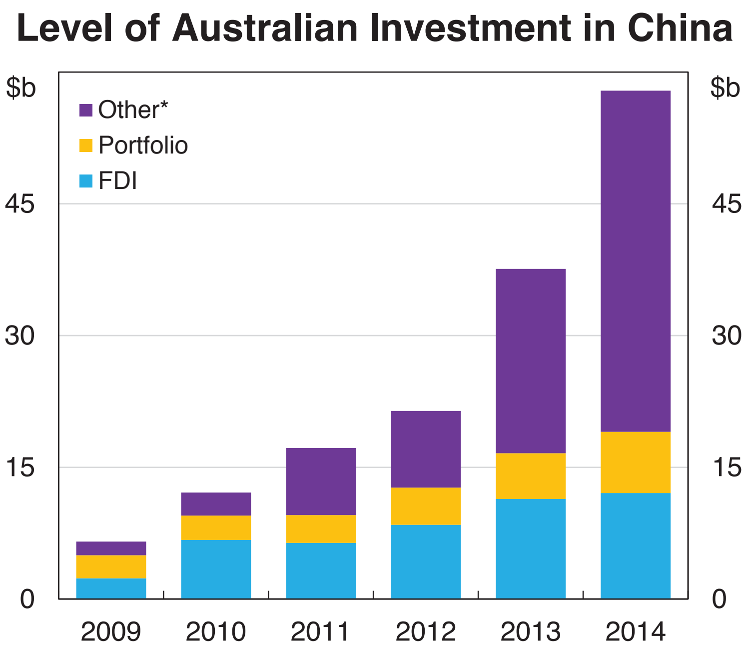
(b) Australian Investment in China

The level of Australian investment in China has increased strongly in recent years, albeit from a very low base, with most of it being in the form of direct investment (Figure 2.5).

While ABS data on Australian direct investment in China by sector are not available, all of the major Australian banks have an increasing presence in China, as reflected in the rise in Australian banks' foreign claims on China. These claims, which represent lending to China by Australian owned banks, have risen very strongly in recent years, from just A$ 5.4 billion seven years ago to A$ 45.4 billion in June 2015[54]. While still constrained by capital controls and other regulations, other parts of Australia's financial services sector, such as insurance and funds management, also have direct investments in China, albeit quite limited overall in size.

54 Source: The Reserve Bank of Australia (RBA) Statistical Tables, Table B13.2.

Figure 2.5: Level of Australian Investment in China



* Includes currency and deposits, loans, trade credit and advances, accounts receivable, and financial derivatives
Sources: ABS; RBA

One of the very positive spillover effects from Australia's strong trade links with China and from Sydney being designated as an official RMB centre is that, as over time finance follows trade, Chinese direct investment in NSW and in Australia more broadly is likely to grow strongly. As a major capital importer, this should be welcomed and encouraged at both a state and national level. Similarly, direct investment in China by Australian companies brings domestic benefits and should also be welcomed. Indeed, in the two areas identified below as providing the greatest scope for building up RMB business in Sydney and in Australia more broadly, namely transactional banking business and funds management, a presence in mainland China is often required in order to take full advantage of the emerging opportunities for cross-border financial transactions. Such investments are very much part of developing Sydney as an RMB hub and add to domestic jobs, profitability and tax revenue.

CHAPTER FOUR:
Transactional Banking Business

As was noted earlier, the bulk of transactional RMB banking activity centres on trade: for example, providing foreign exchange services, derivatives products for hedging, cash management services, term deposits and trade financing.[55] In addition, and in particular for those Australian banks with a significant presence in mainland China, facilitating two-way direct investment flows is also a key focus.

All four major Australian banks have a presence in China but varied levels of exposure[56]. The activities conducted by the banks depend on the type of licences obtained[57] and whether or not the bank is locally incorporated in China. By way of example, a foreign bank can hold a general banking licence which allows it to conduct foreign currency business in China with both retail and institutional clients (onshore and offshore), including products such as mortgages, deposits and term loans; and a separate RMB licence which allows it to offer RMB banking products and services to onshore Chinese corporates. It can also hold a retail RMB licence, but this can only be granted to locally incorporated banks, not to onshore branches of foreign banks.

- ANZ has a broad range of banking licences and was the first Australian bank to be locally incorporated in China. ANZ also taps into CNAPS. In addition to local incorporation, ANZ has six branches and two sub-branches. ANZ also has joint ventures with Shanghai Rural Commercial Bank and the Bank of Tianjin, with 20% and 14.16% stakes respectively.
- Westpac has branches in Beijing and Shanghai. The Shanghai Branch is a direct participant in CNAPS.
- The Commonwealth Bank has a branch in Shanghai and a representative office in Beijing. It has a 20% stake in both the Bank of Hangzhou and Qilu Bank and a Memorandum of Understanding with Bank of Communications. It also has a number of county banks in Henan and Hebei provinces that are licenced to service local SME's and individuals.
- National Australia Bank has both a Shanghai and Beijing Branch.

The table below outlines the main licenced activities of each bank.

ANZ has the largest presence in China and indeed Asia of the four major Australian banks.

55 Beyond such trade-related banking products and services, banks may of course also provide other services, longer-term RMB investment opportunities for both corporate and other clients and capital markets services for companies looking to raise RMB capital. However these services are considered separately in the following two chapters.

56 The following only covers banking activities, not funds management or insurance operations.

57 These licences do not affect the capabilities of Australian banks to service Chinese companies in Australia.

Its banking business in China is outlined in more detail in Box 2.2 below.

As noted above, two of the major Australian banks have equity stakes in Chinese banks. At present, China's regulatory limit on such joint ventures is 20% equity, but it is possible this may change over coming years. The strategic objective of such joint ventures can vary from bank to bank, but typically includes issues such as increased local brand recognition and market access; obtaining insights from the local partner; and/or broadening relationships with governments and regulators in China.

A general banking licence does allow foreign banks to conduct RMB business for foreigners but separate approval is required for foreign bank branches to offer RMB service to corporates. To be able to offer RMB to local residents, foreign banks need to become locally incorporated first and apply separately for such a licence.

Table 2.1: Australian Banks in China

Banking activities	ANZ	Westpac	CBA	NAB
General Banking Licence – RMB deposit, lending, FX spot, money market, trade finance and cross border business for companies located in china (not individuals)	X	X	X	X
Derivatives – including FX forwards, swaps and fixed income with mainland Chinese companies in China	X	X	X	X
Commercial RMB – RMB lending and deposit-taking for foreign individuals, foreign and Chinese companies	X	X	X	X
Retail RMB – RMB lending and deposit-taking for Chinese individuals	X			
Shanghai Free Trade Zone Presence	X	X	X	
Market Maker – direct trading in AUD/CNY in China	X	X		
China interbank bond market quota – provide services to onshore and offshore institutions investing in the Chinese bond market	X		X	

An issue which was raised by both banks and insurance companies in discussions is the prudential capital requirements in Australia as they relate to joint venture investments. The Australian Prudential Regulation Authority (APRA) requires all equity exposures in other companies, including positions in joint ventures, to be fully deducted from equity for capital adequacy purposes. However, the Basel III recommendation (which is applied in most other jurisdictions) only requires a capital reduction if the aggregate investment is greater than 10% of the bank's own capital base. As a result of this more conservative approach - which is consistent with APRA's broader approach to regulation, which is more conservative than the minimum capital requirements set by Basel - Australian banks are generally required to hold up to four times the capital of some foreign banks in offshore JVs.[58] The change came into effect in 2011, well after some joint ventures had started; however the rule was not grandfathered.

Echoing submissions to government and government inquiries, a number of banking and insurance companies expressed the view that APRA's capital requirements for equity investments makes joint ventures considerably more expensive for Australian companies compared to many companies from competing countries, and hence restricts the international competitiveness of Australian banks and insurance companies. It has also been seen as inconsistent with the thrust of the recent White Paper on "Australia in the Asian Century" and its focus on broadening and deepening our economic and trade relations with the Asia Pacific region.

The reason why APRA puts a higher risk weighting on joint ventures is clear enough. In the case of China, foreign banks and insurance companies are only allowed a 20% maximum stake in joint ventures in China, which provides them with less control in the event of difficulties. At the same time, there is clearly a balance to be drawn between prudential considerations and competitiveness of Australian companies. The Financial System Inquiry argued that a weakness in Australia's regulatory regime is that there are no requirements for regulatory agencies to explain how they balance these at times competing objectives.[59]

This issue is returned to below.

As RMB-related activity in Australia has increased, all the major local and foreign banks in Australia have expanded the range of RMB products and services available to their customers. The demand for these products and services from Australian domiciled companies, and whether they buy these products from local banks or offshore, depends on a range of factors, most important being the extent to which trade is invoiced and settled in RMB; local liquidity; and (closely related) pricing of products. These factors are examined below.

58 Some foreign banks from jurisdictions adopting the minimum Basel III requirements may have already exceeded the threshold in other investments, and therefore will be required to hold the same level of capital as the APRA requirements.

59 Recommendation 30 of the Financial System Inquiry includes: "Improve reporting of how regulators balance competition against their core objectives."

Box 2.2: ANZ Banking Business in China

Asia is a key focus for ANZ in its overall growth strategy, which is aimed at positioning itself as a major regional bank. During the global financial crisis, many European and U.S. banks showed increased interest in ANZ and in a number of cases started doing business with them, leading amongst other things to their opening an office in Paris, but their focus remains primarily on the Asia Pacific region.

Given on the one hand the fact that they are an Australian bank and on the other the increasing significance of China with respect to both trade and investment flows within the region, the central pillar in ANZ's Asian strategy is Australia/China two-way flows. ANZ has had a presence in China since 1986 and was locally incorporated in 2010. It has branches in Shanghai, Beijing, Guangzhou, Hangzhou, Chengdu, Chongqing and Qingdao, as well as an operations centre in Chengdu. It also has strategic partnerships with Shanghai Rural Commercial Bank and Bank of Tianjin.

While from a funding perspective raising RMB bank deposits in China is important, it is also difficult and expensive given brand recognition issues and the sheer geographic size of China. Reflecting that and other factors, the main focus of ANZ's banking operations in China is institutional and corporate banking, in particular Chinese companies investing in and/or trading with Australia and the region more broadly and Australian and multinational companies investing in and/or trading with China. Their broad regional presence means that they are better able to "connect the dots": for example, by offering cash management facilities and other services to a multinational company doing business in a number of countries in the region.

The key to ANZ's expansion in China was obtaining a local banking licence and then growing the business by way of organic expansion. However, ANZ also has two joint venture (JV) businesses in China, a 20% stake (the maximum allowed in China for banking JV's) in Shanghai Rural Commercial bank - which has the second largest branch network in Shanghai - and a 14.16% stake in Bank of Tianjin. The objective in entering into these JV's was, through the local partner, to obtain local insights, market access and broader relationships with governments and regulators in China. ANZ are of the view that China's policy regarding the 20% limit on foreign ownership in a bank JV may change over time, at least for smaller banks.

In April 2014, ANZ (China) opened a sub-branch in the China (Shanghai) Pilot Free Trade Zone (SFTZ) to help customers take advantage of the opportunities expected to flow from China's ongoing financial market liberalisation. Under the SFTZ's current regulatory framework, the sub-branch will offer a range of banking products and services including business loans, trade finance, foreign exchange, commodity finance and cash management in both foreign and local currencies to ANZ China's customer base of large Chinese and multinational companies. As with many companies that have established a presence in the SFTZ or in other free trade zones, the move is in part a strategic one based on the expectation that the more open arrangements regarding cross-border transactions that apply in the SFTZ are likely over time to be extended to the rest of mainland China.

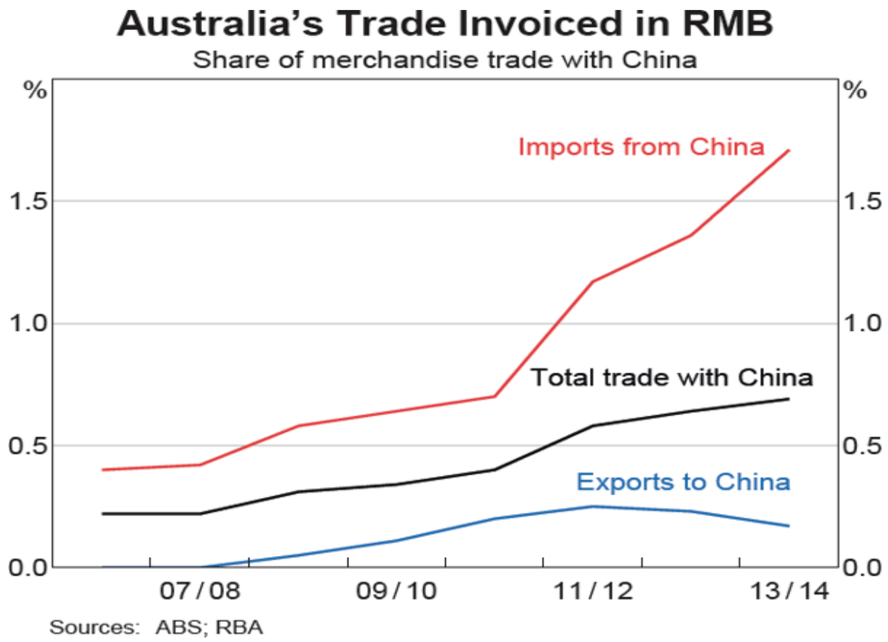
ANZ is one of two Australian banks licenced to trade the AUD/CNY direct cross onshore on CFETS, China's interbank trading platform and in the broader financial market. ANZ is also one of 19 banks with direct participation in the first phase of the CIPS rollout. The system will operate in a similar way to the USD clearing system, CHIPS, by providing Real Time Gross Settlement for both clearing between offshore and mainland China and purely offshore RMB payments.

Funds management opportunities in China are not a priority area for ANZ. In Australia, they recently commenced a joint venture with ETF Securities and will be listing a range of exchange traded funds, including an RMB-denominated ETF, in Sydney. With respect to the RMB ETF, they are unsure what sort of demand there will be: this is more a “toe in the water” move.

Trade Invoicing

At present, the proportion of Australian trade with China that is invoiced and settled in RMB is very small. An analysis of the offshore RMB market in Australia by the RBA[60] shows that at June 2014 less than 1% Australia's merchandise trade with China was invoiced in RMB (Figure 2.6).

Figure 2.6: Australia's Share of Merchandise Trade with China Invoiced in RMB

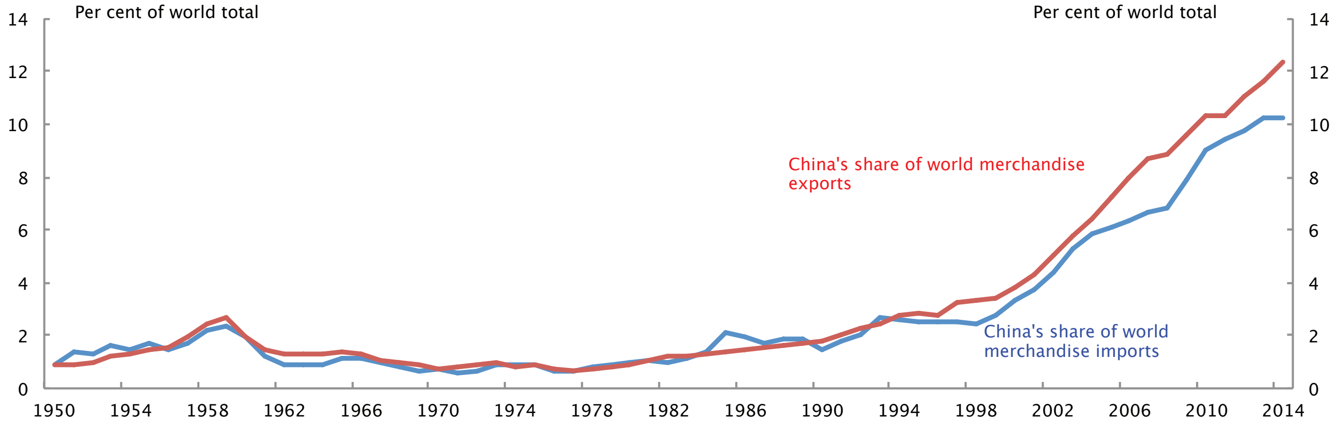


Anecdotal evidence from discussions with banks suggests that RMB invoicing is definitely picking up. The establishment of Sydney as an RMB centre with an official clearing bank may have provided some further momentum at the margin by raising corporate awareness amongst SME's in particular of the possibility of RMB invoicing.

Chapter Two of Part Two discussed briefly the rapid growth in the proportion of China's trade that has been invoiced in RMB and the very good prospects for this to continue to rise. In addition, the volume of China's trade with the rest of the world continues to grow strongly (Figure 2.7).

60 Hatzvi, Nixon and Wright (2014)

Figure 2.7: Growth in China's Share of Global Trade



Source: World Trade Organisation Statistical Database

Are these developments likely to be reflected in a rising share of Australia's trade with China also being invoiced in RMB?

Mention has been made throughout this report of the changing nature of growth and domestic demand patterns in China, associated with both the policy objective of switching to more consumption-led growth and the rapid rise of China's middle class and associated demand for a range of products and services such as healthcare, tourism and financial services. These shifts are already being reflected in changing patterns of Australian trade with China. To take one example, educational services is now one of the largest categories of Australian exports; and China is the largest destination country. Australian exports of educational services stood at $15.7 billion in 2013-14, and have grown to become our fourth largest export category overall.[61] Within this total, educational exports to China stood at A$4 billion in 2013-14, or 25% of the total.[62]

Nonetheless, Australia's export trade with China is still dominated by commodities that are priced and settled in USD. While the changing patterns of Chinese demand and hence of our exports to China may well result in rising RMB settlement, this is less the case with some exports than others: educational exports, for example, primarily take the form of Chinese students undertaking educational courses in Australia, which would be primarily paid for in AUD. In other areas though, such as higher quality agricultural exports and food, there is clear scope for settling in RMB, and in some instances this is already starting to occur.

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61 This figure understates total sales of educational services, since it excludes sales of services through foreign affiliates- a point touched on earlier in this report.

62 Source: Austrade Economics (2015).

In addition, one factor that has been discouraging RMB trade invoicing has been the much lower level of US interest rates compared to Chinese interest rates, which has meant that RMB trade financing has been much more expensive. This seems likely to change in the period ahead. A further reason why corporates have traditionally financed in USD was because the RMB had been appreciating against the USD for several years. This has not been the case since the first half of 2015, and on at least some estimates the RMB is now around “fair value”.

Nonetheless, even allowing for China’s policy objective of switching to cleaner sources of energy, coal and iron ore will remain major components of Australia’s exports to China for a considerable time. Hence a key factor which will influence prospects for greater RMB invoicing in our trade with China over the coming decade or so is likely to be whether the main commodities we trade with China, in particular iron ore and coal, change over time from being priced and traded globally in USD to being widely priced and traded in RMB.

This issue was touched on in the authors’ first report, which noted that China is the single most important source of demand for a range of commodities traded globally and is keen to become a central hub for pricing and trading of commodities in Asia and beyond, including becoming the benchmark price setter in RMB for a range of commodities. It also noted that there are already a number of exchanges in China quoting RMB prices on commodities futures contracts, although “in most cases - and certainly with respect to iron ore and coal - liquidity is limited and trade is mainly between Chinese-based producers and users.”[63]

Since that report was written, China has started to have a larger influence on the pricing of a range of commodities, reflecting both the fact that it is the world’s largest consumer of many of them and also the shift in bargaining power from producers to purchasers as global supply has increased relative to demand. Furthermore, developments in the commodities space have confirmed both China’s commitment to becoming a global price setter across a range of commodities and its strategy for achieving this objective. Firstly, trading volumes in a range of RMB-denominated commodity futures contracts in China have grown massively, to the extent that, across a number of commodities, trading volumes in mainland China now exceed offshore trading volumes. An example of particular relevance to Australia is iron ore. Since it started trading in October 2013, the iron ore futures contract on the Dalian Commodity Exchange in mainland China has seen explosive growth in trading volumes. In the 12 months to August 2015, trading volumes on this contract rose by 294%.[64] The 2014 Futures Industry Association Annual Report stated that it is now the largest iron ore futures contract globally and the third largest metals futures contract by volume. The four top metals futures contracts globally are all listed on Chinese exchanges.[65]

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63 Eichengreen, Walsh and Weir (2014) p. 94.

64 Source: www.dce.com.cn viewed 1 October 2015.

65 Source: Futures Industry Association (2015).

Secondly, China's strategy of building up liquid onshore commodity futures contracts priced in RMB and then making these contracts available to offshore traders, in some cases initially through its free trade zones, has made significant progress. To take a few examples:

- The Shanghai Gold Exchange (SGE) earlier this year launched an international trading board in the Shanghai Free Trade Zone allowing foreign parties to trade RMB-denominated gold contracts;
- The Shanghai International Energy Exchange is looking to set up a futures contract for crude oil priced in RMB by the end of 2015 in the Shanghai Free Trade Zone, which would be open to foreign investors;
- In July 2015 the London Metals Exchange (which in 2012 was bought by the Hong Kong Exchange) announced that it will accept offshore RMB (CNH) as cash collateral for its clearing house following approval by the Bank of England;
- The China Securities Regulatory Commission (CSRC) recently allowed a few large offshore commodity trading companies to access a number of domestic contracts. This is likely to be extended over time; and
- Domestic and cross-border trading of particular commodity contracts may increasingly be moved onto the same board.

Thirdly, and consistent with its desire to link local RMB-denominated futures contracts to overseas entities, China has been extending the local trading hours for a number of its futures markets and is looking to extend them further.

Over time, as these developments make it easier for both overseas commodity exporters and Chinese importers to hedge in RMB and hence be more willing to invoice and settle in RMB, a number of global commodity benchmark prices are also likely to be set in RMB.

Commodities were originally part of the discussions between Hong Kong and Shanghai that led to the establishment in November 2014 of the Stock Connect Scheme, but technical and other difficulties led to this being deferred in the interests of getting the stock market connection up and running. More recently, there has again been discussion about the possibility of extending the Shanghai-Hong Kong Stock Connect Scheme to include commodities. This will, however, not be straightforward: different regulatory arrangements and much higher capital requirements from Chinese clearing houses are examples of issues to be overcome.

China's ambitions and approach in this area are clear enough, but how do developments look from an Australian commodity exporter's perspective? Unless they receive some advantage in the form of higher price or greater volumes, there is no incentive for the major Australian resources companies to ask their Chinese trading partners for RMB settlement. These companies are in effect USD companies, with their treasury and risk management operations primarily in USD. For many Chinese importers, however, the incentive is clear. A Chinese steel producer, for example, will be currently importing commodity inputs paid for in USD but selling output to Chinese purchasers paid for in RMB. The domestic cost of hedging the resultant currency exposure can be substantial, and generally considerably higher in China than offshore. That company could offer a price advantage to an Australian exporter that is less than the domestic cost of hedging the FX exposure but more than the offshore cost, so both parties gain.

For this to occur, however, both the producer and the importer need to be able to hedge their exposure to future commodity price movements in RMB: in other words, both need to be able to access highly liquid RMB-denominated futures contracts. China is fully aware of this, which is why it is pursuing the approach outlined earlier of building up liquidity on a range of RMB-denominated domestic commodity contracts and then opening these contracts up to offshore participants.

Another relevant factor from the perspective of Australian commodity exporters is that, increasingly, rolling stock and capital equipment is being imported from China. Invoicing and settling in RMB is more attractive for a company if it is both paying and receiving RMB.

In conclusion, developments since our first report was written reinforce our earlier view that widespread use of RMB for trade settlement across a range of commodities, including coal and iron ore, is in prospect. Discussions with a number of global commodity experts suggest this is likely to occur within three to five years.

The authors' first report[66] included a survey of company attitudes to RMB trade settlement. The survey was conducted in late 2013 across 103 Chinese and 93 Australian companies engaged in China/Australia trade. Some of the key findings of the survey and related discussions were:

- A willingness by many Australian companies to settle trade in RMB should their Chinese trading partners request it;
- A lack of awareness by many Chinese companies, particularly smaller companies, of the ability to invoice in RMB. Awareness levels in Australia were much higher;
- Some Chinese banks discouraging RMB invoicing because they would miss out on high margin foreign exchange business; and
- Companies in both countries, but especially Australia, waiting for their trading counterparts to either initiate or agree to RMB invoicing.

The surveys, along with related discussions, suggested that constraints to greater RMB trade invoicing lay more in China than in Australia. Because of that finding, another survey of 100 Chinese companies was conducted in early 2015 as part of this report. The key observations from comparing the two surveys are as follows:

66 Eichengreen, Walsh and Weir (2014), pp.95-97.

- Awareness levels in China remain low, with only 70% of respondents aware of RMB trade settlement compared to 69% in the earlier survey;
- In both surveys, only a small number of firms reported that they were currently using RMB for trade settlement. However, for those using it reports of settlement difficulties dropped significantly, from 70% to 14%;
- In the earlier survey, half the Chinese firms expected to increase RMB use in the future. This increased in the second survey to 65% over a one year horizon and 85% over a five year horizon;
- 41% of Chinese firms indicated that the establishment of an official settlement bank in Sydney and strong encouragement from the authorities would increase their RMB settlement.

One interesting finding in response to a question that was in the second survey but not the first was that none of the firms using a trading company[67] to manage their trade and invoicing used RMB for settlement. The reason may in part be that the trading companies are charging their clients a substantial fee for foreign exchange transactions.

Increased RMB trade invoicing is an important component of successful RMB internationalisation. Some of the constraints in China to greater invoicing that have been identified in these surveys may well be of interest of Chinese officials and hence worth raising in future discussions.

Liquidity and Pricing

Part One talked about the issue of offshore RMB liquidity and touched on its possible impact on different areas of RMB business.

There are two interrelated dimensions to this issue. One concerns where an RMB FX transaction is priced and the risk is managed.

The authors' first report, which discussed this aspect in some detail, made the following observation:

"Australia does not need a large pool of local RMB liquidity in order to build up more RMB transactional business over time....For an Australian domiciled bank doing transactional RMB business with an Australian resident client, it does not matter whether the actual execution of that trade occurs in Sydney or via its offices in say Singapore or Hong Kong, where there is more liquidity that makes it easier for the offshore branch to (for example) offset any unwanted FX exposure on the interbank market. All it means is that the Australian head office is a price-

67 Trading companies have a long history in China and traditionally act as a broker between foreign and Chinese companies trading with each other.

taker rather than a price-maker. Nor does it make any difference to the client where the trade is actually executed: the client obtains the same potential benefit from the trade, and the bank gets the fees for the transactional business, whether those fees are booked to its Australian operations or to its offices in Singapore or Hong Kong".[68]

That conclusion remains valid. Indeed, as overall offshore RMB liquidity improves and the links between offshore RMB centres increase - as is already occurring - so the scope for hubs and centres to draw on each other's liquidity increases.

An interesting example on this front is London, the largest foreign exchange market in the world. RMB foreign exchange business in London has grown very strongly. However, as noted in Part One of this report a large proportion of both spot and forward FX transactions booked to London banks were actually transacted through other offshore RMB centres.[69] What these and other data show are that, even for a market as large as London, banks with a presence in other offshore RMB centres such as Singapore and Hong Kong will often do some or all of their pricing and risk management in those other centres. This is also true of Australian banks.

The other liquidity dimension relates to settlement procedures for cross-border trade-related RMB transactions. Trading companies need to be confident that this is done in an efficient and reliable manner, at both ends. The company's bank has to make sure that cleared funds arrive in its own accounts in time for it to make the RMB payment to the client.

The four major Australian banks use different settlement facilities, and some of them use more than one. This is also true for other banks doing RMB business in Australia. As noted earlier, all of these mechanisms generally operate reasonably efficiently. From the client's perspective, in most cases they do not see or care much about the clearing mechanism as long as it operates smoothly and in a timely fashion: they are simply interfacing with their bank in Australia.

Prior to the October 2015 introduction of CIPS, the main clearing processes available were:

- using the official Bank of China/ASX/Austraclear mechanism;
- going through Bank of China (Sydney) but not using the ASX/Austraclear connection;
- going through a correspondent bank in Hong Kong or in another offshore RMB centre; or
- going directly through a correspondent bank or own bank branch in Shanghai.

The official clearing mechanism has the advantage of providing real time settlement and allowing parties to track the clearing process so that they can identify any problems earlier. This may be important for larger trades. However, it has the disadvantage that there is a local clearing fee per trade. How to make the official clearing mechanism competitive with other clearing mechanisms

68 Eichengreen, Walsh and Weir (2014), p. 99.

69 See Part One Figure 1.2.

in Australia is an issue under consideration at the time of writing.

The official clearing mechanism still goes through Bank of China (Hong Kong) and then through to mainland China. If, due to the massive volume of RMB clearing going through Bank of China (Hong Kong), there is some hold-up in the clearing process, this will affect both the official clearing mechanism and the other non-official ones, except for direct clearing via a bank in mainland China.

Part One of this report referred to the fact that in a few other RMB centres, notably Hong Kong and Singapore, the central bank has set up mechanisms for providing intraday RMB liquidity to the market on the back of the swap facility with the PBOC. In the case of Hong Kong, the HKMA in 2014 appointed seven banks as primary liquidity providers (PLPs) with a limited repo facility at the HKMA which they pay for when utilised. However, the facility has on occasion come under pressure and been criticised for being inadequate, as was the case for example in August this year when interbank liquidity dried up and the interbank offered rate rose sharply.

However, in most other countries, including Australia, such liquidity facilities have not been put in place and indeed the relevant central banks do not see it as part of their responsibilities: rather, the function of the swap line with the PBOC is seen as being for periods of severe market disruption, not as a day-to-day facilitation mechanism.

What about the official clearing bank? Is part of its function to provide liquidity to the market? This would seem to make sense from a Chinese policy perspective: the underlying rationale for China in setting up official clearing banks in RMB centres around the world is to increase and broaden geographically offshore RMB liquidity as part of the process leading towards full RMB internationalisation. For this interim step to work effectively, ensuring adequate liquidity exists in each of the offshore RMB centres makes sense.

Discussions which we have held with the domestic banks suggest that, for the most part, intraday liquidity has not been an issue to date, although there may have been a few occasions when it has caused some concern. The official clearing bank does provide some liquidity support for other banks using its clearing facilities, but it is limited in both size and time duration.

This issue is further complicated by the recent launch of the new global RMB clearing mechanism. CIPS has the potential to significantly add to offshore RMB liquidity, with the liquidity being provided from mainland China either via participating banks with support from the PBOC or through some other PBOC supported mechanism. Just how this will be done remains to be seen. At present, the PBOC can provide offshore liquidity during periods of market disruption by way of its swap facilities with other central banks. With respect to day-to-day liquidity facilitation, when an official offshore clearing bank provides liquidity to other offshore banks this can introduce elements of credit risk and hence credit limits: if for example an Australian bank requires liquidity from Bank of China (Sydney), the official clearing bank, then Bank of China (Sydney) has to use up part of Bank of China's overall credit limit to the Australian bank, most of which will be allocated to Bank of China (Hong Kong).

At a more general level, it is certainly true that, for the RMB to become a major international currency that is widely used for trade, for investment and as a reserve currency, it will be necessary for the PBOC to stand behind it as the ultimate provider of global liquidity and as the lender of last resort in a liquidity crisis, in the same way that the Fed does for the USD. In the interim period leading up to the RMB becoming a major international currency, the PBOC will also need to ensure that offshore liquidity is available widely enough to facilitate the growing importance and use of RMB globally.

It is also possible that, as more two-way trade with China becomes settled in RMB over time, the local banks themselves will become sources of greater RMB liquidity and an interbank market may develop. Because Australia has large volumes of both import and export trade with China, banks dealing with both importing and exporting clients are seeing more two-way FX business. This may make it easier for them to hold balances in that currency on their balance sheet. Nonetheless, it may take some time to reach this point.

Conclusion

Prospects for increased RMB business for commercial banks are very good, as more Chinese and Australian companies invest in each other's markets and as more of Australia's trade with China is settled in RMB.

It will be important to ensure that, as RMB trade volumes increase over time, liquidity does not become a significant constraint, either under existing clearing arrangements or once CIPS is fully in place. This is an issue which could be usefully monitored by the RMB Working Group.

As mentioned earlier, APRA's capital adequacy requirements were raised in discussions with Australian banks:

A number of Australian banks are involved in joint ventures with Chinese banks but feel they are at a competitive disadvantage compared to banks from other countries as a result of APRA's much higher APRA capital requirements on joint ventures. It would seem that a reasonable way to balance prudential and competition objectives would be along the lines of the Basel III recommendation, that is by allowing a "materiality" threshold before these higher capital requirements apply, as most other countries have done. If Australian financial services companies are to compete with overseas companies in building up their offshore activities in the region, changes in this area would seem sensible. This is as relevant for insurance companies as it is for banks.

CHAPTER FIVE:
Funds Management

China is already on some measures the largest economy in the world, and its capital markets are also amongst the largest in the world. However, ongoing capital controls, along with the fact that China is either not represented in a number of key global benchmark indices used by fund managers or its weight is well below its market capitalisation, have meant that portfolio investment flows into and out of China remain limited.

This is, however, changing very rapidly, and on a number of fronts. Firstly, with respect to *inward* porfolio investment flows into China's capital markets:

- China is on the verge of being included in some key benchmark indices, and over time its weight will rise to match its market capitalisation. This will add dramatically to the demand for Chinese assets, both by passive investors who track benchmark indices and by active investors who use the benchmarks to set investment ranges across countries; and
- On the supply side, the scope for accessing China's capital markets is also increasing rapidly with the spread of QFII and RQFII quotas, the commencement in late 2014 of the Shanghai-Hong Kong Stock Connect scheme (see below) and the increased access recently given to China's bond markets.[70]

Secondly, with respect to *outbound* portfolio investment flows from China:

- On the demand side, as China's wealth and associated pool of investable funds increases, so does its need to diversify portfolio holdings into offshore assets in order to optimise portfolio returns and diversify risk; and
- On the supply side, both the Mutual Recognition of Funds agreement between China and Hong Kong and a range of existing and prospective quota systems (see Appendix 2.2) provide increasing scope for both retail and institutional investors in China to invest in overseas assets, either directly or through a funds management vehicle.

Equally importantly but perhaps less widely recognised, the regulations in China regarding what kind of arrangements are permitted for foreign funds management companies wanting to sell their products into China has changed dramatically in recent years.[71]

70 During the course of 2015, China has further opened up access to its interbank bond market to foreign central banks, sovereign wealth funds and international financial organisations, and to more than 30 overseas financial institutions including HSBC, Morgan Stanley and BNP Paribas. Given China's usual approach to market opening measures, it seems likely the list of institutions with access will be further expanded in the near future.

71 Mention was made earlier in this report of the fact that, following the sharp falls in China's equity market earlier this year, the Chinese authorities tightened up on capital outflow regulations. However, the authors see this as a temporary change rather than a lasting reversal in China's commitment to opening up its capital account.

These substantial and ongoing changes in the landscape with respect to portfolio flows into and out of China are creating growing opportunities for Australian fund managers. Chinese institutional investors have shown increasing interest in alternative asset classes, in particular infrastructure and real estate, and these are asset classes in which Australia has long been recognised as a world leader. However, there are also significant challenges for Australian funds management companies, in particular brand recognition in China and distribution.

Both the opportunities and the challenges are discussed below. Section (a) looks at investment in China's capital markets, and section (b) looks at scope for managing funds sourced in China. Most of the focus is on the latter: this is, in our view, a key area of opportunity for Australia going forward.

In our discussions over the past two years with a wide range of fund managers in the course of writing this report and the authors' earlier report, two key observations have emerged:

- On the one hand, more Australian funds management companies, both large and boutique, have identified the considerable opportunities opening up in China and are positioning themselves to take advantage of them; but
- On the other hand, there are still many Australian funds management companies that are not fully aware of the pace of policy change in China and the associated opportunities that are emerging.

Reflecting these observations, a good deal of this chapter is focused on outlining the nature of recent policy changes and their pros and cons in terms of investing in China and/or raising investable funds in China. It is based on wide-ranging discussions with both Australian companies and some large offshore funds management companies actively engaged in China. It is to a large extent addressed to the second group of companies above, with the objective of hopefully raising awareness of both opportunities and challenges.

(a) Investing in China's Capital Markets

China's equity market is now the second largest in the world and its bond market the third largest. However, access to both by offshore investors remains restricted. For the most part, access for foreign private investors is by way of two main mechanisms: China's qualified foreign investor schemes; and the Shanghai-Hong Kong Stock Connect Scheme. These two mechanisms are outlined briefly below.

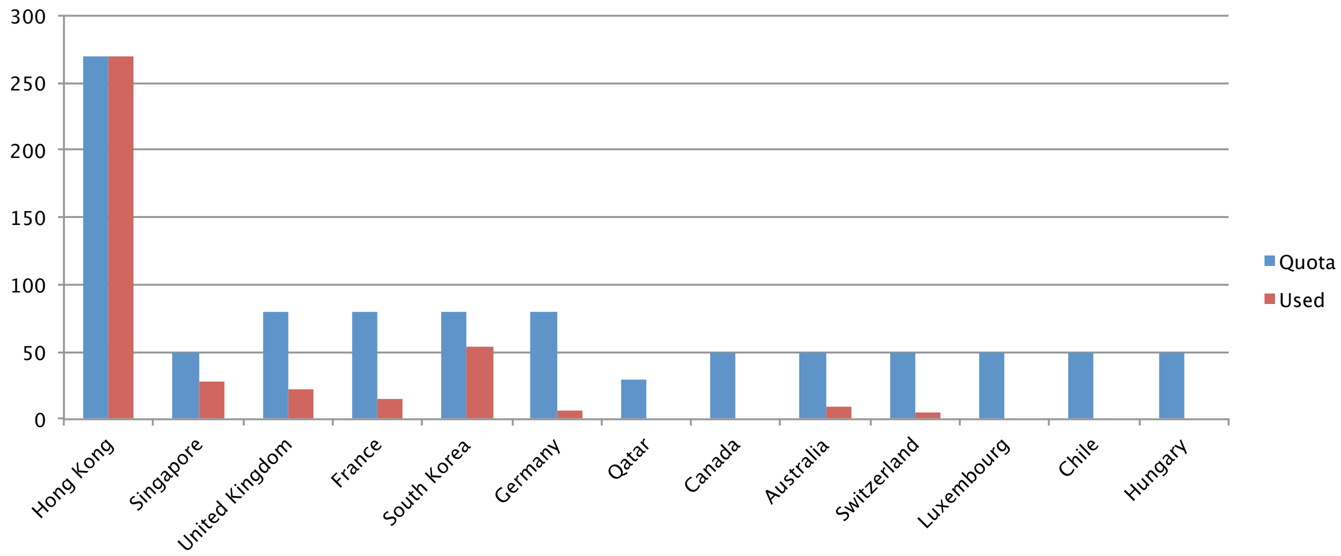
Qualified Foreign Investor Schemes

In December 2002, China introduced its first Qualified Foreign Institutional Investor (QFII) scheme, with a quota of USD 4 billion. Since then, the scheme has been both expanded and liberalised. As of September 2015, the total quota stood at $US 78.7 billion.[72]

Quotas are granted to individual institutional investors. The scheme authorises offshore institutional investors to obtain onshore RMB (CNY) for investment in China's A-share market, in stock index futures and in fixed income products on the interbank bond market.

An additional scheme, the *Renminbi Qualified Foreign Institutional Investor* (RQFII) program was launched in December 2011 with a quota of RMB 20 billion, for use in Hong Kong only. The scheme has since been expanded substantially. In the past two years, quotas have been extended beyond Hong Kong to include amongst other countries the UK, Singapore, France, Germany, South Korea, Luxembourg, Australia and Switzerland, with a total quota of RMB 970 billion (Figure 2.8).[73]

Figure 2.8: RQFII Quota Usage by Country



Source: SAFE (Sept 2015)

The RQFII scheme allows offshore institutional investors with an RQFII licence to invest offshore RMB (CNH) into China's capital markets. Quotas are granted to countries as against individual investors, with financial institutions with a presence in that country then applying for part of that country quota. In practice, RQFII licences have proved to be portable: a company with a presence in one country may use its RQFII allocation in another country in which it operates.

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72 Source: SAFE

73 Table 1.1 earlier listed the quota amount by country. Switzerland (with a RMB 50 bn. quota) is not included in table 1.1 as it does not have an official settlement bank.

As of September 2015, the total number of QFII and RQFII licences was 418.[74]

QFII and RQFII quotas are granted by SAFE, while approval of company eligibility is required from the CSRC. QFII and RQFII quotas have been issued primarily to asset managers, who hold almost 60% of the total licences.

The eligibility requirements and investment restrictions relating to both QFII and RQFII schemes have been significantly relaxed since their introduction. By way of example, in March 2013 the 80% fixed income and 20% equity allocation RQFII restrictions were removed. Appendix 2.1 sets out the main eligibility restrictions applying to QFII and RQFII schemes.

Shanghai-Hong Kong Stock Connect Program

This program was launched on 17 November 2014. It allows investors, both institutional and individual, to access the mainland China A-share market ("northbound" trading) and Chinese investors to access Hong Kong listed shares ("southbound" trading). The initial northbound quota was set at RMB 300 billion and southbound at RMB 250 billion, with daily volume limits of RMB 13 billion and RMB 10.5 billion respectively. As of September 2015, unused quotas were RMB 140 billion and RMB 90 billion respectively.[75] Daily usage in both directions fluctuates considerably but has at times been over 90% of the daily quota; comments from officials suggest the quotas will be increased over time if necessary.

While the scheme had a number of initial teething problems such as differing trade settlement and custodial requirements in the two jurisdictions, these would appear to have been largely sorted out.

It seems likely that this scheme will be extended to include stocks listed on the Shenzhen exchange in the near future. It may over time be rolled out to include other offshore exchanges, such as Singapore.

Pros and Cons of the Different Schemes

In principle, both lack of any substantial eligibility restrictions[76] and the fact that it is available to retail investors are key advantages of the Stock Connect scheme over the QFII and RQFII schemes. However, the QFII scheme has been running now for some time, whereas the Stock Connect scheme is still relatively new and suffered from a number of teething problems and uncertainties. In addition, some large fund managers are wary of the daily volume limits. So, perhaps not surprisingly, there has been no evidence of widespread switching by offshore

74 Source: SAFE

75 http://www.aastocks.com/en/cnhk/market/quota-balance/sh-connect viewed 1 October 2015.

76 Mainland China investors in Hong Kong need to have RMB 0.5 million in their investment accounts, but this is not required for northbound investments.

fund managers from the QFII or RQFII mechanism to using the northbound Stock Connect mechanism. Rather, Stock Connect has generally been considered more of an addition to rather than a replacement for QFII. Whether this changes over time remains to be seen.

At present the RQFII eligibility and other criteria are less restrictive and hence more attractive to most fund managers and investors than the QFII criteria. By way of example, investors in QFII vehicles are subject to a lock-up period of between three months and one year, whereas RQFII open-ended funds have no lock up period. More recent changes to the QFII scheme[77] suggest that the Chinese authorities are moving towards harmonising and possibly merging the QFII and RQFII schemes, making the QFII requirements largely the same as for RQFII. For that reason, a number of funds management companies we spoke to that hold QFII quotas are not bothering to apply for RQFII licences.

Overseas Investment in China's Capital Markets

As noted earlier, China's equity market is now the second largest in the world and its bond market the third largest. However, due to both capital controls and a range of other factors, foreign participation in those markets remains very limited: in the case of China's equity market, foreign participation is around 1%; foreign holdings in China's bond market, while rising rapidly, are still only around 1%.[78]

Apart from capital controls and the associated QFII, RQFII and Stock Connect quota limits on foreign participation in China's capital markets, a further factor explaining this limited foreign participation is the key role played by portfolio benchmarks. As noted earlier, in addition to the very large number and size of passive funds that track benchmark indices as closely as possible, most active funds use market benchmarks, such as the MSCI equity indices and the Barclays (formerly Lehman) bond indices, to set ranges for their allocation to different countries. Many supposedly active funds, both in Australia and overseas, have come under criticism from a number of quarters for in fact being "index huggers".[79]

On the equities side, China's weighting in the MSCI World Index is currently only 1.1%, although its total equity market capitalisation - including A, B and H shares and Red Chips[80] - is some 8.1% of total world equity market capitalisation.

In July 2015, MSCI announced that, following a comprehensive review, it had decided against

77 On 13 August 2015 SAFE issued a QFII draft guideline setting out further relaxation of a number of QFII conditions, such as simplifying firm-level quota transferability

78 Source: Bloomberg and SAFE.

79 See for example in Australia's case Minifie (2015).

80 A-shares are mainland Chinese companies listed in mainland China and only accessible to offshore investors via QFII or RQFII quota schemes or via Stock Connect. H-shares are mainland Chinese companies listed in Hong Kong. B-shares are mainland Chinese companies listed in mainland China especially for international investors. "Red Chips" are companies that are listed in Hong Kong, not incorporated in mainland China, but effectively controlled by mainland Chinese entities.

adding China's A-shares to its main emerging market indices at that time, but also announced establishment of a joint working group with the CSRC with a view to adding A-shares by 2017, targeting a possible initial 5% inclusion and

then moving towards a market capitalisation weight over time as China relaxes and removes its capital controls and undergoes other market reforms.

Some USD 1.7 trillion in global assets are currently benchmarked to the MSCI Emerging Markets Index, the most important index in this asset class. If Chinese A shares were included in the index at their current market capitalisation, Chinese shares overall would represent around 44% of the index.[81] Over coming years as China's benchmark index weighting rises towards its market capitalisation weight, as capital controls are further relaxed and as market confidence in China's capital market rises, hundreds of billions of dollars are likely to be reallocated from other emerging markets into China's markets. Over time, China will also become a major component of global indices, not just emerging market indices.

Other index providers have moved earlier than MSCI. In May 2015, FTSE Russell - another important equity benchmark provider - announced that it would allocate a 5% weighting to China A-shares in two new emerging market indices, with a plan to move over time to a weighting possibly as high as 32%. FTSE Russell referred to the growing global allocation of RQFII quotas as a central element behind this decision, with the 5% weighting related to then total RQFII allocations of around RMB 364 billion. The announcement prompted Vanguard, one of the largest global asset managers, to announce that it would transition to this new FTSE benchmark and associated A-share weighting in its Emerging Markets Stock Index Fund.

On the fixed income side, China is not included in most of the widely followed global emerging market benchmark indices that exclude all countries with capital controls, such as the JP Morgan Government Bond - Emerging Market Global Diversified Index. However, it is included in other indices where both market capitalisation, liquidity and the extent of offshore access via such schemes as QFII and RQFII are taken into account. An example is the HSBC Asia Local Bond Index (ALBI), where China's weight is currently around 13% and rising as the size of the offshore quotas and other access mechanisms increases. In the JP Morgan Government Bond - Emerging Market Broad Index, where even countries with capital controls are eligible for inclusion and therefore respective market size has a larger influence, China's weight is currently around 28%.

In short, as is the case with respect to equities, as China continues to increase offshore access to its capital markets it will become a major component of many fixed income benchmark indices and hence of global bond portfolios.

The IMF will soon announce its decision as to whether to include the yuan in the basket of SDR currencies (see Appendix 2.3). Such a move - which is increasingly only a question of when,

81 Source: MSCI (2015).

not if - may further add to the attraction of RMB-denominated assets, both in the official sector as part of central bank reserves and in private portfolios.

Australian Portfolio Investment in China

Australian portfolio investment in China is currently small but growing. At the official level, the Reserve Bank of Australia currently invests 5% of its reserves in RMB.

In the market sector, demand for exposure to China from Australian investors is seen by most market participants as increasing, albeit slowly and from a very low base. The recent very high levels of volatility in the Chinese equity market to some extent work in both directions: while they have improved valuations, they have also led to concerns with respect to the Chinese Government's response to the volatility and what that might mean going forward.

What little Australian exposure there is overall to Chinese capital markets is mainly done indirectly, that is by an Australian funds contracting out portfolio management to an offshore fund manager. However, there are signs of more of non-$A portfolio management being shifted in-house, including by industry funds.

At present there are only three Australian financial services companies with QFII licences: Platinum Asset Management, AMP and Macquarie. Between them, they use these quotas for a variety of purposes, including both mutual funds with exposure to China A-shares and also internal proprietary trading and exposure to China. Other funds with exposure to China tend to do it either through the Shanghai-Hong Kong Stock Connect scheme if they have a presence in Hong Kong, or through H-shares: that is, Chinese companies listed in Hong Kong. While the latter approach significantly limits the range of Chinese companies that can be accessed, discussions with a number of fund managers suggest some are happy to accept this limitation in return for better corporate governance and legal certainty in Hong Kong. This once again reinforces an earlier point in this report concerning the importance of China improving not just market access but also market confidence in its capital markets and their regulation if RMB internationalisation is to succeed.

In November 2014, Australia was granted a $50 billion RQFII quota which allows offshore RMB (CNH) to be used to invest in China's capital markets, but to date only one company has applied for and received a licence for part of this quota, namely Vanguard, who received an RMB 10 billion licence in January 2015. They will be using the RQFII licence for both active equity funds and ETF's run out of the U.S., although the trade execution will be done out of their Melbourne office who do all of Vanguard's execution for the Asian region. Market discussions suggest that a number of other financial services companies in Australia are thinking about applying for an RQFII licence, in some cases for setting up RMB ETF's and in other cases for active funds. A number of large global fund managers such as Van Eck have Chinese A share ETF's listed on the ASX, but these are based on QFII or RQFII quotas obtained elsewhere.

In summary:

While at present exposure to China by Australian funds is very small, it is likely to grow rapidly over the coming decade as:

- *China's capital markets become a sizeable and growing share of benchmark indices;*
- *China remains one of the fastest growing major global economies; and*
- *There is increasing need for greater diversification of Australia's pool of superannuation savings into offshore assets.*

(b) Managing Portfolio Outflows From China

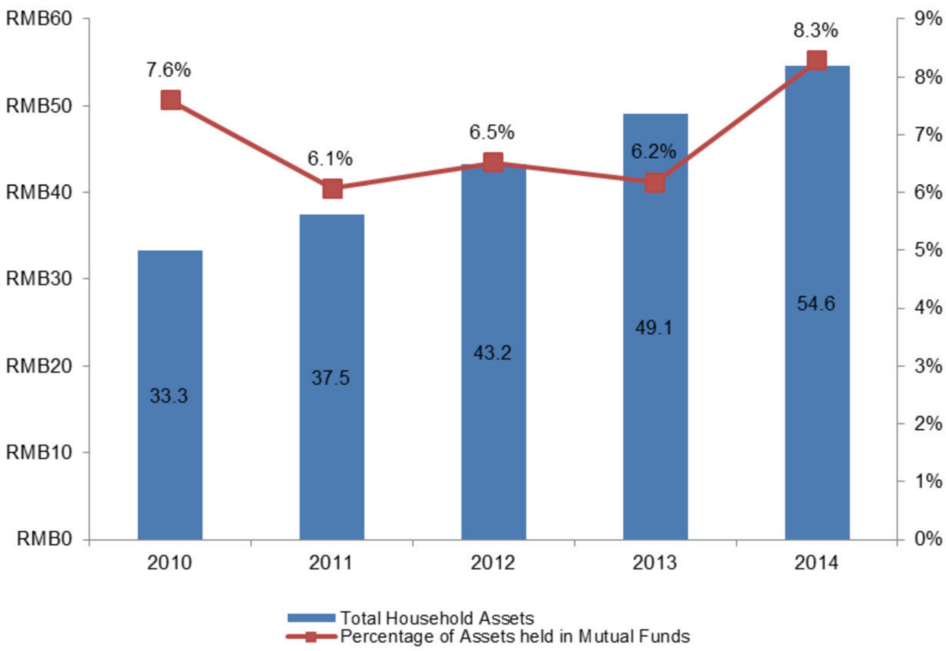
The Opportunities: Savings Pools in China

Mention was made in Chapter Two Part Two of the very large pools of savings in China and the growing pressures to diversify their investment into more overseas assets. Reflecting these pressures, China now has a number of schemes, referred to as qualified domestic investor schemes, which allow eligible mainland Chinese investors to invest in offshore assets. These are in effect approved "windows" in China's capital controls as they relate to outbound investment. Some of these schemes relate to individual investors and some to financial institutions, such as domestic mutual funds or insurance companies. Some of them have been in operation for some time, some are new, and some are yet to be fully developed and announced in terms of their details. Most of the existing schemes have quota limits attached to them.

Appendix 2.2 summarises these various mechanisms allowing Chinese investors to invest offshore. Press reports suggest that further mechanisms are being developed.

Looking in more detail at the nature of these savings pools in China, in the case of the household sector the bulk of savings for many less sophisticated investors is currently held in low-yielding bank deposits, but this is changing as China's financial markets develop and mature and as rising household wealth sees an increasing search for more sophisticated and higher yielding savings options. While the proportion of financial assets held in mutual funds in China remains small, it is increasing (Figure 2.9 below) and is likely to continue to grow over time.

Figure 2.9: Chinese Household Financial Assets, 2010–2014 (RMB trillion)



Sources: People's Bank of China, China Ministry of Human Resources and Social Security, Cerulli Associates

The Chinese household sector is often described by fund managers as the "holy grail". Its size and prospective growth as household wealth continues to rise mean the potential is enormous, but many middle income retail investors in China are still heavily focused on domestic assets: property; shadow banking higher yielding deposits and risky wealth management products; domestic equities; and cash. In addition, their time horizon on domestic equities is often very short, looking for quick capital gains rather than "buy and hold" investments.

This is, however, starting to change, especially in the case of higher net worth retail investors. Chinese mutual funds holding QDII licences (see appendix 2.2) are able to invest into approved overseas asset classes, either directly or through an offshore fund. This has provided opportunities for foreign companies to manage some of these offshore assets, and there have been numerous examples - some successful and some not - of larger and better known overseas companies entering the mutual fund sector, usually by way of a joint venture. Roughly half of the Chinese mutual funds are in fact joint ventures with foreign asset managers.

Looking beyond the household sector, the pools of investable savings in both the corporate and the public sectors are also enormous and growing rapidly. Table 2.2 provides a summary.

Table 2.2: Chinese Institutional Investable Assets, 2009–2013 (RMB billions)

	2009	2010	2011	2012	2013
Retirement					
Public Basic Pension System	1,894.2	2,313.5	2,917.9	3,773.7	4,473.5
National Social Security Fund(1)	776.6	856.7	868.8	1,106.0	1,241.6
Enterprise Annuities	252.5	280.9	357.0	482.1	603.5
Retirement market size	**2,923.3**	**3,451.1**	**4,143.7**	**5,258.4**	**6,209.1**
Outsourced AUM (%)(1)	21.0%	18.5%	17.4%	17.8%	18.9%
Central bank					
People's Bank of China Foreign Exchange Reserves	16,355.3	18,769.5	20,246.6	20,915.7	23,363.4
Insurance					
Life insurance (General and separate accounts)	2,775.5	3,369.9	3,760.9	4,495.0	4,914.4
Sovereign wealth fund					
China Investment Corporation	2,238.5	2,665.3	3,020.0	3,605.6	3,960.3
Institutional market size	**24,292.6**	**28,255.8**	**31,171.2**	**34,274.8**	**38,447.2**

(1) Includes all third-party managers for enterprise annuities, not restricted to fund management companies.

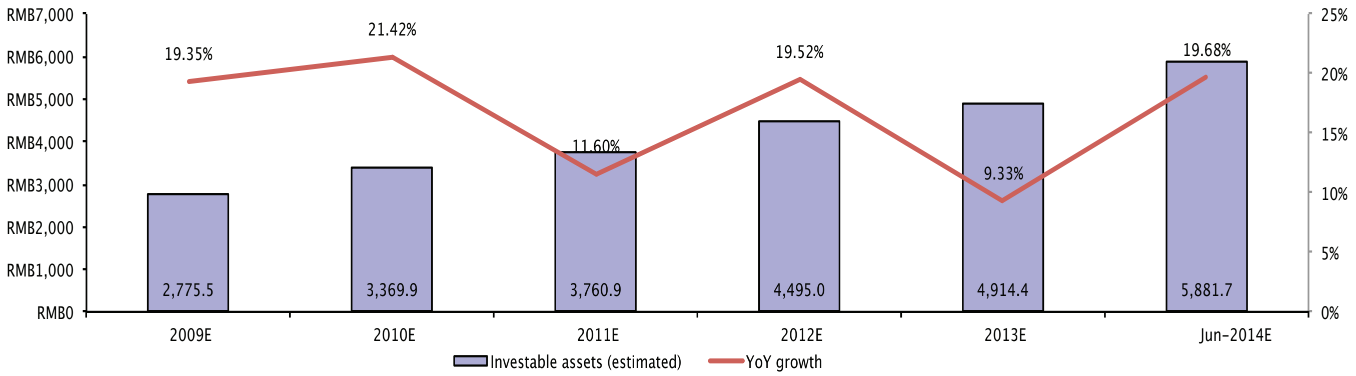
Source: Cerulli Associates

In the case of the corporate sector, much of the savings are held on the balance sheets of large state owned enterprises. At present the main avenue for investing them offshore is by way of direct investment, which is being actively encouraged by the Chinese Government. The authors' earlier report noted that China's ongoing need for greater security of energy and food supplies is likely to remain a key driver of higher levels of direct foreign investment, and Australia is likely to remain a major recipient. This is in the interests of both countries, and should be encouraged.

The insurance sector is another important source of corporate savings in China, and its investable funds are growing very rapidly as the expanding Chinese middle class look increasingly for insurance services (Figure 2.10).

For the insurance sector, the potential for significantly greater offshore investments over coming years is substantial. Its investable assets are growing rapidly, and managing future liabilities in the form of growing insurance claims as efficiently as possible means that the sector needs to further diversify investment of these assets, including moving more into offshore assets.

Figure 2.10: Chinese Investable Life Insurance Company Assets, 2009–June 2014 (RMB billions)



Reflecting this reality, recent regulatory changes have allowed insurance companies to invest a larger proportion of their assets offshore. However, to date the insurance sector has only invested around one tenth of its 15% offshore investment limit. Indeed, the sector as a whole is still in an early phase of putting in place expertise and structures that allow it to invest offshore in a wider range of assets.

Much of the offshore investment to date has been conservative in nature, such as into liquid, short dated fixed income products, but this is also changing, with growing interest in direct investment into property and infrastructure. Australia, as one of the approved destinations for offshore insurance sector investments, has been a beneficiary.

Why does the insurance sector - and for that matter many other institutional Chinese investors - favour direct rather than portfolio investment in property and infrastructure? One reason for this may be the very poor experience with managed funds focused on domestic equities and Chinese equities listed in Hong Kong in the years following the 2007 market peak. Other reasons why the insurance sector would appear to favour direct over portfolio investment include the following:

- It is seen as providing higher returns, providing greater transparency and control, and also longer term cash flows that better match the liabilities side of insurance company's balance sheets;
- Regulations regarding offshore portfolio investment by this sector remain tighter than for direct investment; and
- Insurance companies are more familiar with direct investments.

In addition, the REITS structure for managing portfolio real estate investments has only recently received regulatory approval and is not yet well known in China. This is likely to change over time.

Turning to the government sector, China's managed exchange rate regime and history of large current account surpluses have led to extremely strong growth in public sector savings in the form of foreign currency reserves. In the past these were heavily invested in US Treasuries, but increasingly - in the interests of higher returns and better risk management - they have been invested into other currencies and a broader range of assets. Investment of these foreign exchange reserves is the responsibility of both SAFE - a public sector body overseen by the People's Bank of China - and CIC, China's main sovereign wealth fund.

Of the two bodies, SAFE has arguably been the more active in moving into offshore assets and handing out external mandates, but data on its offshore investments are harder to obtain than for CIC. CIC's investable assets have increased substantially in recent years, from around RMB 2.2 trillion in 2009 to just over RMB 4.5 trillion in 2014[82]. While data are not available on CIC's asset allocation between domestic and offshore markets, in 2014 68% of its global portfolio holdings (a subset of its total assets) were externally managed, compared to 63% in 2013[83]. The majority of these would have been foreign managers or direct assets. CIC's 2014 Annual Report noted that the number of external fund investments had increased significantly during the year[84].

One of the fastest growing and potentially most important sources of external mandates is China's National Social Security Fund (NSSF). The State Council set up the NSSF in 2000 with the mandate of building up its investment expertise and providing strong returns for the development of a national pension fund. Successive Chinese governments have given a high priority to developing a comprehensive national pension scheme, and this has very much remained the case under the present Government, which announced in late 2013 its plan to have state-owned enterprises pay a 30% annual dividend into the NSSF by 2020. In addition, 5% of IPO proceeds from the listing of state owned enterprises is also paid into the fund. The objective of building a national pension scheme, including the expected likely handover of more regional pension funds to NSSF[85], is likely to see NSSF assets continue to grow very strongly, with increasing allocation offshore. The most recent data available suggested that NSSF's overseas assets were just 8.5% of its total assets, as against the maximum limit of 20%[86].

Reflecting these policy objectives, the investable assets of the NSSF have grown strongly, from around RMB 770 billion in 2009 to RMB 1.6 trillion in 2014[87]. As of June 2014, it had some 66 external mandates, of which 38 were overseas mandates. In 2014, total external mandates represented just under 50%% of total NSSF assets, up from 46% in 2013[88].

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82 Source: China Investment Corporation (2014) p. 60.

83 Source China Investment Corporation (2014).

84 China investment Corporation (2014) p. 36.

85 It seems likely that, as the Central Government steps up its objective of establishing a comprehensive national pension scheme, the NCSSF - the body that oversees the NSSF- may increasingly take responsibility for managing both central and regional pension funds. In 2012, Guangdong province allocated some RMB 100 billion to the NCSSF.

86 Source: National Council for the Social Security Fund (2014).

87 Source: NSSF.

88 Source: National Council for the Social Security Fund (2014).

Mechanisms for Accessing and Managing Chinese Sourced Funds

Reflecting China's commitment to opening up its financial markets as part of the move towards RMB internationalisation, the mechanisms by which offshore fund managers can potentially access investable funds in China is expanding. Indeed, the pace of policy change in this area is accelerating.

The main mechanisms for accessing Chinese investors are as follows:

- By winning mandates directly from Chinese institutional investors, such as CIC, SAFE or the NSSF, or managing offshore assets on a sub-advisory basis for QDII licence holders in China such as banks or mutual funds;
- Through entering into a JV with a Chinese financial services company;
- By setting up a Wholly Foreign Owned Enterprise (WFOE). In mid-2015 there was a major change in what foreign companies can do in the funds management space in China, such that wholly foreign owned financial services companies can now hold a securities trading licence in China which enables them to engage in a wide range of funds management activities, including operating a funds management platform. However, at present this change appears to apply only to high net worth and institutional clients, not to retail clients through a mutual fund; and
- By selling Hong Kong domiciled mutual funds into China from Hong Kong, through the Mutual Recognition of Funds agreement between the two jurisdictions.

Each of these mechanisms are examined in detail in Appendix 2.4, which also outlines some of their pros and cons based on discussions with domestic and overseas market contacts. Some of the key points made in Appendix 2.4 are as follows.

Firstly, arguably the two biggest hurdles for Australian funds management companies trying to raise funds in China are brand recognition and distribution. Of the various mechanisms for accessing investable funds in China, operating by way of a joint venture with a Chinese company that already has a well-recognised brand and widespread distribution network is perhaps the most obvious way of overcoming these hurdles. However, operating a successful JV requires investing a lot of time into building trust and getting to fully understand the regulatory system. It also requires, critically, finding a partner with a similar business culture and closely aligned goals. Box 2.3 below outlines a successful example of an Australian company entering into a JV in China, and some of the key factors behind its success.

Some of the potential disadvantages of entering into a JV in China are lack of ultimate control (majority funds management partnerships in China are not currently permitted); and the risk that the Chinese partner will extract as much intellectual property as possible from the foreign partner and then look to exit the partnership.

Secondly, as noted earlier two of the most promising sources of institutional funds for offshore foreign investors to date have been CIC and the NSSF. Managing mandates for such bodies on a fully discretionary funds management basis is clearly an attractive option, usually requiring less of a presence in mainland China. Partly for that reason, the competition for such mandates is enormous. AMP's success in this area is perhaps a good demonstration of the value of having a longstanding presence in China and a history of senior level contact with some of the key regulatory bodies and decision makers – as well as, crucially, a good performance history and high rating of its REIT capabilities (see Box 2.3 below).

Thirdly, the Hong Kong/China Mutual Recognition of Funds (MRF) scheme has been operational since 1 July 2015. One potential advantage of using this mechanism is speed to market. However, it remains to be seen how this pans out: the CSRC in August 2015 confirmed that the period between application and approval could take up to six months. On the negative side, for companies that do not have them already, establishing a presence in Hong Kong and gaining at least one year's investment performance as required can be expensive and time consuming. In addition, using this route does not solve the key issues of distribution and brand recognition, unless the Hong Kong based company is also in a JV in China or enters into an agreement with a distributor.

Finally, with respect to WFOE's, the most often quoted advantage is that it provides protection of intellectual property. The disadvantage - in particular compared to a JV - is that it does not directly solve the two biggest hurdles for many foreign companies, namely local distribution and brand recognition. However, there is scope for a funds management WFOE to enter into a JV or a commercial partnership with a Chinese company with respect to distribution, joint branding, marketing and/or sales. These regulatory changes are opening up many new possibilities.

Which Model is Being Primarily Used by Overseas Asset Managers?

There is no single answer to this question. As noted earlier, some half of the 90 mutual funds in China are JV's with foreign companies. However, some of the largest global funds management companies have a policy of not entering into JV's. Some of them have WFOE's in China; some of them are managing institutional mandates from offshore on a sub-advisory basis; some are looking to access China through funds established in Hong Kong, using the Mutual Recognition of Funds agreement; and some, particularly the larger ones, are using more than one of these models.

The proliferation of mechanisms is itself having an impact on the way in which overseas financial services companies are thinking and operating. Suppose you are a large international funds management company wanting to sell some of your products into mainland China. You are not interested in doing it via a minority holding in a joint venture with a Chinese company. One option you have been thinking about is setting up a Wholly Foreign Owned Enterprise in the Shanghai Free Trade Zone and selling initially just to companies with a presence in the zone, in the hope that in the near future this free trade zone experiment will be rolled out more broadly and you will be able to sell the fund across China. Now, with the recently announced change allowing wholly owned foreign companies to engage in a wide range of funds management operations in mainland China, perhaps this is a better approach? Or, now that it is operational, should you establish a presence in Hong Kong and then once you have a track record utilise the Mutual Recognition of Funds mechanism?

However, you are also aware that China is reportedly working on a new QDII2 scheme (see Appendix 2.2), and if you could obtain a QDII2 licence you could manage the funds where you already have the relevant people and resources, which you would prefer. Which way do you jump?

In the case of very large companies keen to establish an "early mover" advantage, the response to date to the variety of avenues opening up for accessing investable funds in China has often been one of “strategic optionality”: you work on a number of options and then, as it becomes clearer which avenue is opening fastest and over time is likely to best suit your needs, you channel more resources into that one.

However, to pursue this “optionality" approach you need at least two things:

- plenty of resources, which enable you to initially invest in multiple options; and
- reliable information from mainland China about what the regulators and government are thinking and doing and how the different access routes will likely pan out.

For smaller companies that cannot meet these two requirements, one strategy in the short term may be to wait and see how these various "windows" in the capital account expand and develop. In the interim, however, larger, better-resourced and better-informed companies may be stealing the march on you.

One of the lessons that many would take away from this, be it in the funds management space or in other areas of financial services, is that there is often no substitute to having a presence on the ground in mainland China that enables you to keep in close contact with the relevant government officials and with actual and prospective policy developments, as well as better understand the local market and the key participants in it. In addition, working closely with government officials from your country of domicile who are based in mainland China and are themselves in close contact with Chinese officials may also be very useful.

These observations are returned to below.

A number of large overseas hedge funds have also entered the Chinese market by way of China’s Qualified Domestic Limited Partner Program (QDLP), (see Appendix 2.2). Launched in 2013, the scheme allows offshore fund managers to set up wholly owned companies in China to bring together domestic investors in limited partnerships that buy offshore alternative assets. In the first round of the Shanghai-based QDLP scheme, only six hedge fund managers, which included U.S.-based Och-Ziff Capital Management Group LLC, Citadel LLC, and UK-based Man Group Plc, received a quota of $50 million each. Market contacts and reports suggest the six have had mixed success in raising funds, possibly reflecting a reluctance by some of them to outlay the large amount of capital necessary to establish their sales and distribution networks. This is perhaps not surprising given the low $50 million limit on the assets each fund could raise.

More recently, a further five foreign hedge fund and private equity managers - UBS Global Asset Management, Deutsche Asset & Wealth Management, Nomura Asset Management, EJF Capital and CBRE Global Investors - have been approved to establish local firms to raise RMB from Chinese investors to spend on alternative offshore assets. In addition, the investment limit has been raised significantly. While the Chinese hedge fund industry is still in its infancy, it will be interesting to observe how the overseas entrants fare and how market access is increased going forward.

What do Australian Fund Managers Have to Offer?

While the opportunities for managing investable funds sourced in China are substantial, so is the competition. What does the Australian funds management sector have to offer that may provide some advantage?

Australia's financial sector is very highly regarded in the region with respect to rule of law, the quality of its regulatory system, the quality of its banking system and the size and sophistication of its funds management sector. Unlike a number of US and European banks, our banks are not seen as having been partly responsible for the recent global financial crisis; indeed, our financial sector came through the crisis with its reputation enhanced. Many Chinese delegations have travelled to Sydney in recent years to observe and learn more about how our financial sector operates and is regulated, and how our superannuation system works. At the same time, being a smaller economy, we are perhaps more sensitive to the fact that the institutional, cultural and regulatory frameworks and mores relating to how business is done are different across countries and need to be fully respected.

The Australian funds management sector is one of the largest in the region, with highly sophisticated distributional systems and world class risk management systems. The Chinese funds management sector by contrast is still in early development phase. In addition, many of the large institutional investors in China have only been given permission and encouragement a to undergo offshore portfolio investments in recent years, and have limited experience in managing global portfolios.

Herein lies an important part of the opportunity for Australian companies. One way of building up relationships and partnerships with Chinese financial services companies is to begin by providing technological and training support in areas such as portfolio construction, risk management and sales staff training, and then over time seek to also manage portfolios on behalf of the strategic partner. As noted earlier, most JV's with Chinese financial institutions that have the capacity to manage funds include a clause giving them first right to manage overseas portfolios flowing, for example, from the Chinese partner obtaining a QDII licence.

A good example of an Australian company that has followed this approach is AMP Capital. Its operations in China, and some of the reasons for their success, are examined in Box 2.3 below.

Box 2.3: AMP's China Business

a) Joint Ventures

AMP has had a representative office in China since 1997. Its relationship with China Life commenced in 2005, but it was not until 2009 that AMP signed a Memorandum of Understanding with China Life, which included potential cooperation on investments and pensions.

AMP's longer-term objective in entering into the Memorandum of Understanding was to establish a strategic relationship built on trust and, through these engagements with China Life, gain greater clarity on the value that AMP could bring to the Chinese market. This could subsequently provide AMP with an early mover advantage as market reforms gathered momentum. In particular, AMP was waiting for regulatory change allowing Chinese insurance companies to establish mutual fund companies.

In October 2013, China Life became the first Chinese insurance company to set up its own funds management company. It set up a joint venture with AMP Capital, which was China Life's first joint venture in mainland China with a foreign partner in financial services. AMP Capital took a 15% stake in China Life AMP Asset Management Company. The company currently offers retail and institutional investors in China access to investments in listed equities, fixed income and money market products. Its first mutual fund was launched in January 2014 and there are now 11 public mutual funds.

This mutual fund business has grown very rapidly. Indeed, from inception to 2015 it has been the fastest growing mutual fund business in China and is now amongst the top 50, with RMB 70bn funds under management. It can raise funds from a variety of sources, including corporates, other insurance companies, high net worth individuals and retail investors.

All of the funds are managed within the joint venture company. AMP provides support in a number of areas including sales, product development, risk management and investment strategy.

In October 2014, AMP also took a 19.99% stake in a China Life enterprise annuity (defined contribution) provider, China Life Pension Company. This was an established business that had been operating since 2008. It was the first time a foreign company had taken a stake in a pension insurance company in China.

China Life Pension Company provides defined contribution corporate pension schemes. As with its other JV, AMP does not manage any of the underlying assets but rather provides support across a number of areas including sales and distribution, product development, investments, operations, IT, finance and risk management. China Life Pension Company is the top-rated enterprise annuity company and the largest private pension provider in China.

AMP sees the growth potential for both of these JVs as enormous. One reason for this is that expanding pension scheme coverage, including defined contribution enterprise annuity schemes, is a major policy priority in China.

In addition, AMP is hoping to be able to manage pension and mutual fund money invested in offshore assets at some point in the near future. AMP sees Chinese retail and institutional investors increasing their offshore assets over time. More broadly, AMP sees ongoing developments in China's financial markets as opening up enormous opportunities for overseas fund managers, be it as sub-advisers or through JVs.

What does AMP see as the key to the success of its JVs? Amongst the more important factors are AMP's proven and prudent track record in Australia as the country's largest insurance company; patience; investing a lot of time building trust; showing respect for Chinese culture and understanding China's regulatory system and ways of doing business; and not trying to impose foreign systems and ways of doing business on China Life. A further critical factor is that the two companies have similar, cautious cultures and closely aligned goals. The fact that both started as insurance companies and then (in China Life's case only recently) branched out into funds management and pensions, together with AMP's longer track record in this space, meant that AMP has relevant experience that can be applied in China. AMP's experience with Australia's superannuation system has also been very relevant as China moves to establish a national pension system. China Life is very interested in the AMP/Australian experience, seeing how to use aspects of the way things are done here and improving on them.

Another important factor has been AMP's continuous presence in China for more than 17 years. Following the global financial crisis, many European and US financial services companies exited China, which was seen as demonstrating a lack of-long term commitment to the country.

What does AMP bring to the two JVs? Experience and, where sought, advice with respect to issues such as governance structures, risk management, training of sales staff and distributional platforms. As an example, AMP has been involved in training life insurance agents to become financial planners in a trial project in Shandong province (population 80 million; China Life has 25,000 life insurance agents in the province).

Why did AMP go down the JV route rather than other potential routes? The key to success in China is distribution, and with one million sales staff China Life has enormous distributional reach. While another potential distribution channel is via Chinese banks, the fees charged by banks are typically very high.

Is AMP concerned about loss of intellectual property and that over time it will become redundant? While this is often raised as one of the key risks for JV operations, the reality is that many JVs in China have in fact shown longevity. A key factor to such longevity is not wanting to dominate the relationship and instead working as a partner. It is also important that the relationship does not become static: AMP is continually looking for new areas in which they may be able to add value. In addition, the sharing of experiences is two-way. There are areas where AMP can learn from China Life.

Would a majority ownership JV be better if they were permitted? Possibly in the case of a JV with a small Chinese company, but AMP sees better value in a smaller stake in a JV with a very large partner such as China Life.

AMP's JV input is managed from Beijing with substantial input from Sydney, including a dedicated China team based in Sydney, and with a good deal of two-way travel between the two JV partners. AMP has no permanent staff in the JVs but it does have senior staff members in mainland China focused on building and managing relationships with key stakeholders. Indeed, establishing trusted relationships with key stakeholders has been critical for AMP's success in China.

b) Other Business in China

In addition to the two JVs with China Life in China, AMP separately manages pension money for the National Council for Social Security Fund (NCSSF), the body which oversees the NSSF, which is invested in AMP Capital's global listed real estate capability. AMP Capital's global listed real estate team has fund managers on the ground in Australia, Asia, Europe and the US.

AMP's success in gaining the NCSSF mandate is a good demonstration of the value of having a longstanding presence in China.

Is AMP considering further avenues for expanding its business in China? AMP's two existing JVs with China Life are the key focus. AMP sees significant growth potential through these two JVs, with access to two of the largest platforms in pension and mutual funds. With the Chinese market going through continued reforms, AMP now has the platform, knowledge and insight to identify and capture the next phase of its China growth strategy.

\With respect to portfolio management, what advantages does our funds management sector have to offer China? We are of course good at managing $A assets, but the opportunities here are very limited given the small size of our capital markets relative to the size of the pools of investable funds in China.

However, we are also world leaders at managing infrastructure and real estate assets, including global or regional portfolios. As has been mentioned on a number of occasions, these are asset classes of growing interest to Chinese institutional investors.

Mention was made earlier of the opportunities starting to open up in China for offshore hedge funds under China's QDLP, which allows offshore hedge funds to establish and raise capital in mainland China. Australia has the second largest hedge fund sector in the Asia Pacific region after Hong Kong. While the Chinese hedge fund industry is in its infancy, rising real wealth in China and further market opening measures by the authorities are likely to see emerging opportunities for Australian hedge funds and private equity firms.

China has welcomed the prospect of increased participation in its financial sector by Australian funds management companies. In a side letter to the China/Australia Free Trade Agreement, the Chinese Minister of Commerce, Mr. Gao Hucheng, stated the following:

"China welcomes the participation of Australian private equity and funds investors in the Chinese market as qualified foreign investors. Australia and China will strengthen future cooperation to facilitate greater Australian mid-market size funds investment participation in China, as well as options to strengthen Australia-China Renminbi (RMB) fund partnerships in China."[89]

What Are Australian Funds Management Companies Currently Doing with Respect to Managing Funds Sourced in China?

What is the current state of affairs with respect to offshore sourced funds managed in Australia in general, and funds sourced in China in particular? A 2014 Financial Services Council/Perpetual report[90] incorporated both good news and not so good news on this front.

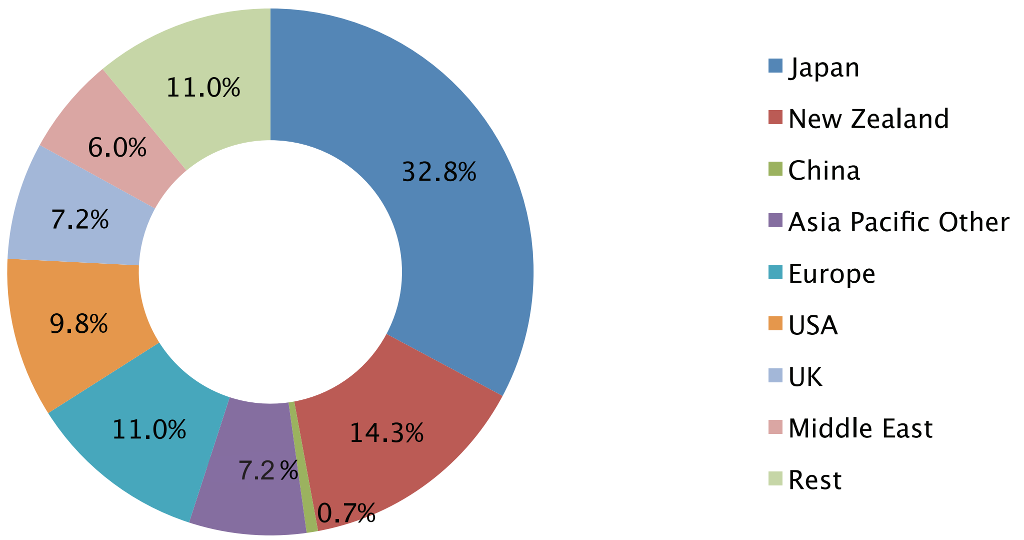
The funds surveyed covered roughly half of the total amount of overseas sourced funds managed in Australia. On the one hand, the survey showed that inflows from foreign investors into managed investment trusts in Australia roughly doubled over the four years to end 2013, from $20.3 billion to $40.4 billion. The Asia Pacific region was by far the largest source of these funds, at 55% of the total. The Deloitte Access Economics study referred to earlier suggested that management of these overseas sourced funds contributed $434 million in value added to the Australian economy.

89 Letter to Hon. Andrew Robb AO MP, Minister for Trade and Investment, 17 June 2015.

90 Financial Services Council and Perpetual (2014).

However, on the other side of the coin is the fact that, as noted earlier, foreign sourced funds as of March 2015 still represented only 3.5% of the total $2.4 trillion in funds managed in Australia, around the same percentage as four years earlier. In addition, the FSC/Perpetual survey suggested that China represented only 0.5% of total overseas sourced funds. Japan was by far the largest source of funds in the region, followed by New Zealand. (Figure 2.11).

Figure 2.11: Sources of Fund Investment in Australia from Overseas (Dec 2013)



Source: Financial Services Council and Perpetual (2014).

As has been stressed in this report, opportunities in China are increasing rapidly due in part to ongoing policy changes, many of which have occurred since this end 2013 survey was conducted. Are more Australian fund managers taking advantage of these emerging opportunities in China? Anecdotally, the answer is yes, and the number doing so is growing, but it is still small in overall size.

At present, most Australian fund managers who are managing Chinese sourced money or are currently positioning themselves to soon do so are focused on institutional savings pools such as the insurance sector, the NSSF, CIC, and ultra-high net worth individuals. There would appear to be very few Australian fund managers currently looking to target the Chinese retail investor sector. Perhaps consistent with this observation, of the 100 funds in Hong Kong that are eligible to use the Mutual Recognition of Funds framework to sell mutual funds into mainland China, only one is an Australian owned company.[91] However, this may well change over time as access to this market segment opens up further.

As noted earlier, two asset classes of growing interest to institutional Chinese investors are infrastructure and real estate: asset classes in which the Australian financial services sector has considerable expertise. In many cases these Chinese institutions, in particular the larger ones, are looking for direct investments rather than portfolio investment into fund structures, for reasons discussed earlier. This may well change over time. A number of the larger Australian financial services companies are already taking advantage of this strong institutional demand for real estate and infrastructure assets.

However, it is not only large financial services companies that are looking for or establishing opportunities in China: there are also a number of smaller boutique firms that are doing so. Some of them are finding overseas property and infrastructure assets to meet the needs of Chinese institutional investors. In some cases this involves simply matching up real estate asset owners looking to sell down to institutional Chinese buyers; in other cases, or jointly, it involves the firm setting up its own global real estate and infrastructure funds specifically targeting Chinese institutional and high net worth investors. This may be done for example through partnerships with well-known Hong Kong or mainland Chinese private banks, who handle distribution and may also help overcome the problem of brand recognition by way of joint branding.

Another focus for some Australian companies has been helping Chinese investors using the Significant Investor Visa program to find suitable compliant investments in Australia. Other companies are targeting high net worth Chinese investors more broadly.

The Significant Investor Visa (SIV) scheme is designed to attract higher net worth investors and to provide a streamlined pathway to permanent residence in Australia for business people from around the world. To date, 90% of visas granted have been to Chinese nationals (Figure 2.12 below). A second and more recent objective has been to improve liquidity in parts of the Australian market that have struggled to obtain adequate funding: SIV rules changed on 1 July 2015 and now require $5million in complying investments to earn permanent residency, with more restrictive asset allocation rules than the previous model. These rules no longer allow for investment in real estate. The complying investments and asset allocations are:

- At least $500,000 in registered venture capital, growth or private equity investments;
- At least $1.5 million in local emerging companies (can invest through managed funds or listed investment companies); and
- $3 million balancing investment in eligible assets (can be less if the investments in the above are greater).

91 Liang (2015).

A Premium Investor Visa (PIV) is also available and offers fast track to permanent residency for international investors. The PIV has been introduced to attract a small number of talented and entrepreneurial individuals who can deliver a long-term economic benefit to Australia. The program is by invitation only, requires $15 million in complying investments and provides a 12 month pathway to permanent residency.

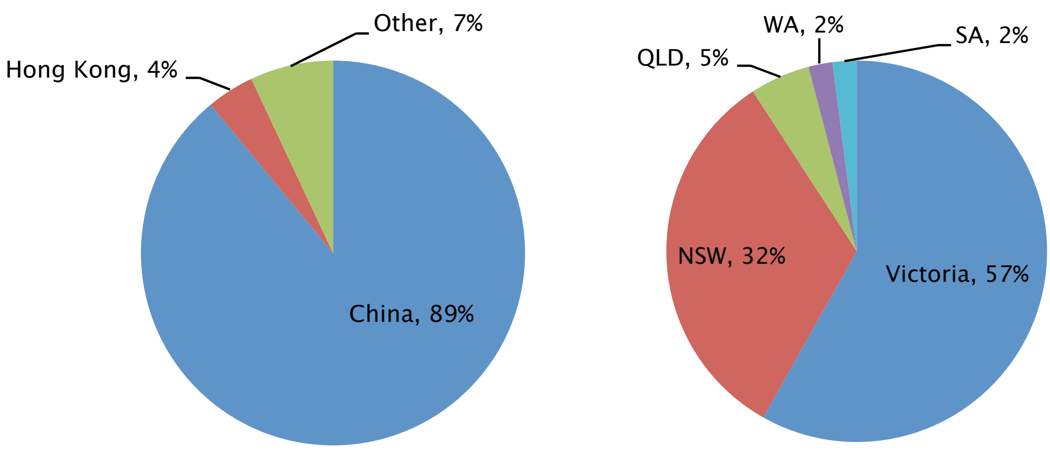
There is no cap on the total number of visas issued.

The Significant Investor Visa and Premium Investor Visa schemes provide an important mechanism for increasing Chinese investment in Australia and encouraging higher net worth Chinese migrants. Furthermore, they also provide a potentially important link into the growth and development of new financial technology (fintech) companies in Sydney. Using current approval rates as a base, Basis Point Consulting[92] forecast the flow of SIV funds into venture capital funds going forward could be $350 million per year. Resident fintech entrepreneurs and ventures could potentially be a significant recipient of some of these funds.

However, this will not be achieved as a matter of course. Firstly, there are some concerns that Chinese investors will be put off by the new asset allocation requirements and would instead prefer a more conservative asset allocation[93]. Providing information to potential Chinese SIV and PIV applicants about Sydney's fintech hub and the investment opportunities it provides could be of considerable benefit.

Secondly, NSW would appear to be falling behind in attracting SIV investors. Figure 2.12 depicts the distribution of visas by state. Victoria dominates the program with 57% of the visas awarded compared to 32% from NSW. These charts predate the introduction of the new investment rules; however, market feedback suggests that this pattern has continued.

Figure 2.12: SIV Applications by Country of Origin and State, March 2015



Source: Department of Immigration and Border Protection

92 http://basispoint.com.au/

93 Rose (2015).

Discussions with stakeholders suggest that, if NSW wishes to increase its take-up of these visas, it needs to improve marketing and support services, in particular by wider connection with fund managers and migration agents in NSW and by more active marketing in mainland China, as Victoria is doing. Including representatives of the fintech community in such marketing may provide advantages both in terms of attracting more Chinese high net worth residents in NSW and also providing an important funding source for fintech ventures.

In a number of areas including notably e-commerce, China is a world leader in fintech innovation. One area of focus for a number of fintech companies, both in Australia and overseas, has been development of new and more efficient technologies for cross-border payments. There may be merit in including fintech developments and opportunities, including in the area of cross-border payments systems, on the agenda for a forthcoming Sydney Shanghai Finance Symposium.

This issue is returned to in Chapter Nine.

The Outlook: Removing Constraints

Why has the Australian funds management sector been somewhat slow in identifying opportunities in China and indeed elsewhere in Asia? At a broad level, two possible reasons stand out:

- the size and legislated growth in the pool of superannuation savings has meant that most of the retail funds management sector has been very domestically focused, and has not perceived any great need to grow funds under management by attracting offshore investors; and
- When it comes to portfolio diversification into non-$A assets, many fund managers simply allocate out to offshore fund managers rather than look at opportunities to manage the assets in house. Consequently, they simply do not have the capability to manage non-$A assets on behalf of offshore investors.

On the first point above, growing downward pressure on fees is one factor pushing some retail fund managers to look for offshore mandate opportunities and economies of scale. This factor is also relevant to the second point. In a mandate number of cases, both downward pressure on fees and also the desire to improve oversight and control of the asset management side of their operations has seen some Australian funds in recent years starting to focus more on building up in-house management of portfolios including non-$A portfolios. In addition, and as mentioned earlier, in two asset classes - real estate and infrastructure - a number Australian funds management companies already have very good track records and a wealth of experience.

As has been emphasised in this paper, raising investable funds in Asia, including in China, is not easy. Emphasis has been placed in the discussion above on the difficult issues of brand recognition and distribution in China. In addition there are the cultural differences, different regulatory structures and approaches to regulation, different approaches to corporate governance and rule of law, and many others.

These can all be extremely challenging issues to navigate. Dealing with them adequately can be expensive, as it will often require a presence on the ground in China. For many fund managers, the barriers and costs are simply too high, and it makes good commercial sense to just focus on the domestic market. For many others, however, China provides an enormous opportunity to leverage the company's skills and experience and gain economies of scale in the process- a potentially crucial advantage given the downward pressure on fees in Australia.

There are, in addition to market constraints, a number of significant policy constraints that discourage fund managers from looking to raise funds offshore. The 2009 Johnson Report on "Australia as a Financial Centre" focused on what it saw as the key constraints making it difficult for Australian domiciled funds management companies to manage funds sourced offshore. Some of those identified constraints were very similar to the above market constraints, in particular branding and distribution. However, the Johnson Report also saw one of the main obstacles as being policy related - namely, Australia's tax treatment of cross-border financial flows. It made a number of key recommendations focused on removing these constraints, including:

- Introduction of an Investment Manager Regime (IMR) to remove the considerable uncertainty regarding the tax treatment of overseas investors investing through an Australian domiciled fund; and
- Introduction of a broader range of tax flow-through collective investment vehicles, to deal with the fact that the dominant vehicle in Australia, the managed investment trust (MIT), is not widely used or recognised in Asia, including in China.

Focusing on the difficulties of navigating different funds management regulatory frameworks across countries in the region, the Johnson Report also recommended negotiation of an Asia Region Funds Passport designed to make it easier for a fund that is registered in one passport country to be offered in each of the other passport countries.

While it took considerably longer to put in place than it should have, workable IMR legislation was finally passed earlier this year. It represents a leading example of what can be achieved through close co-operation, negotiation and trust between the financial services sector and financial services policy advisers, in this case Treasury, and has been widely welcomed by the funds management sector.

With respect to the negotiation of an Asia Region Funds Passport, Australia has been at the forefront of this initiative, which is being progressed under the auspices of APEC. A non-binding Statement of Understanding committing signatories to participate in the initiative was signed by ministers representing Australia, Japan, Korea, New Zealand, the Philippines and Thailand on 11 September 2015. While China is not a party to the initiative, it is conceivable it could join at some point in the future as the initiative hopefully expands to include other countries in the region. As part of the consultative mechanisms set up under the China/Australia Free Trade Agreement, ASIC is working with the CSRC on enhancing mutual co-operation and understanding between the two regulatory bodies.

With respect to alternative funds management vehicles, Treasury has done a considerable amount of work in this area. However, at the political level, the issue has now been put on the agenda for the White Paper Tax Review. The timetable for completion of the review and for implementation of policy changes arising from it, including possibly on alternative funds management vehicles, is open-ended.

The delay in consideration of introducing alternative collective investment vehicles that can be used to sell funds management products into China and Asia more broadly is extremely unfortunate. The usefulness of having an IMR in place which provides greater tax certainty for offshore investors investing through an Australian vehicle is substantially reduced if the investment vehicles available are not ones that overseas investors are familiar or comfortable with.

Furthermore, Australian fund managers not only need the right vehicle to sell into Asia: they also need to establish a track record that is credible beforehand, which often means a track record in a fund structure that is used and understood overseas. This is very relevant in the case of China, given the pace of change in regulations and the new opportunities that may open for selling funds managed offshore up in the near future.

In addition, the usefulness of having in place an Asia Region Funds Passport will be substantially reduced if Australian fund managers do not have access to collective investment vehicles that investors in other passport countries are familiar with.

This issue is also returned to in Chapter Nine below.

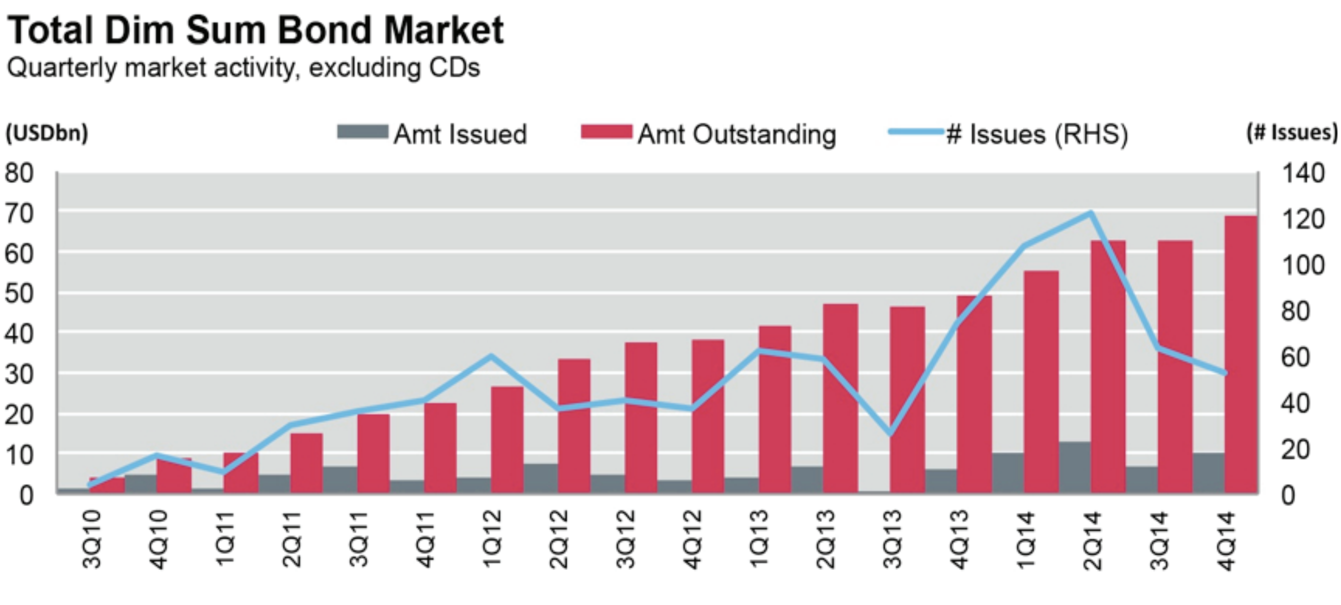
CHAPTER SIX:
Capital Markets

Introduction: Liquidity Constraints

As China opens up its capital markets and moves towards a freely floating exchange rate, the use of RMB for capital account as well as trade account transactions will grow rapidly. This will include increased capital raising in RMB, both by Chinese companies looking to expand domestically and offshore and by offshore companies looking to establish or increase their presence in China. Indeed, the dim sum bond market, encompassing companies issuing RMB-denominated bonds outside of mainland China, is already growing rapidly (Figure 2.13).

Given that, in a matter of just a few years, China will likely have the largest capital markets in the world and will be a major component of benchmark investment indices, the extent of RMB-denominated capital market activity - both primary debt and equity issuance and secondary market trading - is likely increase substantially going forward.

Figure 2.13: Growth of Dim Sum Bond Market[94]



Source: Fitch, Bloomberg

94 Jamieson and Bauer (2015).

What role can Sydney realistically look to play in this area? The authors' first report noted that Australia does not have large pools of RMB liquidity and that, while this may change over time, it is likely to be a gradual process.[95] One of the issues raised in Part One of this report was the relationship between local RMB liquidity and the types of activities an RMB centre such as Sydney could realistically look to add value in. It was suggested, using London as an example, that the growing flows between offshore RMB centres and the fact that most major banks have a presence in a number of these centres means that lack of large pools of local RMB liquidity should not constrain the capacity of Australian domiciled banks to grow their RMB transactional businesses and product offerings.

Similarly in the funds management space, this report has suggested that, due on the one hand to mechanisms such as QFII, RQFII, and Stock Connect, and on the other to the range of structures allowing Chinese investors to invest in offshore vehicles, lack of large local pools of RMB liquidity in Australia should not prevent Australian funds from either investing in China's capital markets or managing money on behalf of Chinese investors.

But what about capital markets activity? Can Sydney realistically hope to become a hub for companies, either Australian or foreign, wanting to issue RMB-denominated debt or equity? Or does success in this area require large pools of domestic RMB liquidity?

Liquidity in capital markets comes from having a large number of both issuers and buyers in the primary market and significant turnover volumes in the secondary market. On the issuance side, it is certainly the case that over time, more Australian companies are likely to establish businesses in China and more Chinese companies are likely to establish businesses in Australia. Both could potentially decide to raise RMB funds capital in Australia. What might lead them to issue here, rather than in other offshore centres or - as China's capital controls are further relaxed - in mainland China?

A key component of that decision is pricing, which in turn depends on demand - although demand may come from offshore as well as from the country of issuance. A second is the regulatory ease of issuing capital in different jurisdictions. A third component is having an efficient clearing and settlement mechanism.

On the demand side, an obvious potential source of demand is the funds management sector. The point was made earlier that, as China continues its corporate governance reforms and further opens up its capital markets to overseas investors, it will become a significant and growing component of global benchmark indices used by both active and passive fund managers, both with respect to equities and fixed income. As this occurs, demand for RMB-denominated assets by fund managers will grow and over time become substantial as China's weight in these indices gradually moves up towards its enormous market capitalisation.

95 See discussion on this issue in Eichengreen, Walsh and Weir (2014) pp 98-99.

However, as has been the case to date with non-$A assets, many fund managers will likely contract out management of such investments to overseas fund managers who specialise in China. Even for those funds that manage such investments internally, they - like the offshore managers - are likely to focus on buying the bonds in markets where the liquidity is greatest and they can most easily manage their risk.

On the second component - regulatory ease of issuing - Australian requirements on the equities side are certainly stricter than in some overseas jurisdictions, but with good reason: while encouraging companies to list or dual list in Sydney may be a sensible objective, doing so by easing listing rules would risk “adverse selection” problems down the track as companies that were unable to meet stricter rules elsewhere engaged in “regulatory arbitrage”. This point is returned to below.

On the bond side, the 2009 Johnson Report on “Australia as a Financial Centre” argued that one of the weaknesses in Australia’s financial markets was the lack of liquidity and diversity in our domestic $A bond market. The report found there were no obvious policy constraints in this area in relation to issuance in the wholesale market, including with respect to regulatory requirements; however, it found that regulations regarding the issuance of bonds to retail investors were unnecessarily onerous and expensive, and should be relaxed. Sensible policy changes have subsequently been made in this area which has to some extent encouraged such issuance, but overall the market is still lacking in depth and diversity.

Turning to the third factor that can influence where a company issues, namely ease of clearing and settlement, since the establishment of Bank of China (Sydney) in conjunction with ASX’s Austraclear platform as the official clearing mechanism, the ASX has been working on broadening the scope of Austraclear so that it has the potential to clear not just trade-related currency transactions but also RMB-denominated bonds and equities and a range of RMB-denominated derivative instruments. It is looking to be able to provide customers with an array of RMB-denominated products and services, all settled through the same platform. With over 840 Australian financial institutions and their customers having access to Austraclear, the potential here is obvious. Box 2.4 below outlines the ASX’s plans and possible timetable in this area.

The remainder of this chapter looks in more detail at some issues surrounding scope for building up RMB debt and equity issuance and secondary trading.

Box 2.4: ASX and Development of the Austraclear Platform

As "finance follows trade", more Australian companies are likely to establish businesses in China and more Chinese companies are likely to establish businesses in Australia. Both could potentially decide to raise RMB-denominated capital in Australia, as could other companies. What might lead them to issue here, rather than in other offshore centres?

One key component of that decision is having an efficient clearing and settlement mechanism. Since the appointment in November 2014 of Bank of China (Australia), in conjunction with ASX's Austraclear system, as the official clearing bank, ASX has been working on extending the clearing and settlement capabilities of Austraclear to include a broader range of RMB transactions. More specifically, ASX is insourcing the Austraclear platform from an external vendor and is now working on a technology transformation initiative that will deliver multi-currency capability - including RMB. Priority in terms of asset classes is being given to bonds: their objective is to be able to clear RMB bond issuance in the next two to three years.

Another key component of the decision on where to issue and clear a bond is pricing, which in turn depends on demand. The ASX recognise that, if this initiative is to succeed, they need to work with potential buyers of RMB-denominated assets such as super funds to make sure they also meet their needs. Providing bondholders with the necessary instruments to manage their risk is a prerequisite for encouraging local demand. Reflecting that fact, the ASX is also building Australia's capacity to handle RMB-denominated derivative instruments such as swaps, options and futures.

A further example of working with potential buyers of locally issued RMB bonds would be providing RMB repo facilities for holders of the bonds. The ASX is assessing the demand from customers and examining the capacity to do this through Austraclear. An example could be providing RMB liquidity management through intra-day repos.

What about equity issuance? This is not as high a priority at present as debt. The ASX is not seeing any significant growth in Chinese firms listing here, although there has been a fair amount of interest recently from companies wanting to move away from US offshore listing. More broadly, they are looking at making available exposure to international listed entities here through depository receipts structures.[96]

96 Depository receipts structures are transferable financial securities, usually in the form of equities, that are traded on a local stock exchange but issued by a foreign publicly listed company.

Will local liquidity be a significant constraint in building this business? This is seen as something of a "chicken and egg" issue: liquidity for domestic transactions will improve substantially if more banks use the Austraclear RMB settlement service, and better liquidity will encourage more of them to use it. Also having the central clearing mechanism here and the collateral held here rather than overseas can be an important plus, including for the regulators.

Bond Market

As was noted in Part One, Luxembourg has successfully carved out a niche for itself with respect to RMB business, despite its small size and trade links. In particular, it has become a European hub for both RMB-denominated funds and also for RMB capital markets business, being the primary European location for dim sum RMB bond issuance (that is, RMB-denominated bonds issued outside of mainland China), listing and trading. Are there any lessons Australia can learn on the capital markets side from Luxembourg's success?

Luxembourg has long been a centre of international bond issuance and listing, going back to the 1960's and the growth of the Eurobond market. Initially, Eurobonds were USD denominated bonds issued offshore so as to avoid a US-imposed Interest Equalisation Tax that was designed to reduce American demand for foreign securities denominated in foreign currencies. If these securities were denominated in USD, the tax could be avoided, and this led to rapid growth in such issuance. The first one was issued listed on the Luxembourg Stock Exchange in 1963.

The term Eurobond is now used more broadly to refer to an international bond denominated in a currency not native to where it is issued. Luxembourg has continued to play a central role in the Eurobond market.

A key element in Luxembourg's success in both becoming the main European centre for licensing of managed funds and also a centre for Eurobond issuance and secondary trading has been its business friendly tax and regulatory systems and the low cost of registering a fund or listing a bond in Luxembourg. This is to some extent a reflection of Luxembourg's small and undiversified economy and its associated "all of government" approach to attracting financial services business to its jurisdiction. As volumes increase, so it becomes easier to maintain this low cost, low tax approach.

Luxembourg has also become the European headquarters for a number of major Chinese banks, who tend to use it as their regional centre for granting RMB commercial loans to their European customers. It has also become the European headquarters for a number of Chinese non-financial companies. These have been key factors behind the build-up of RMB liquidity in Luxembourg and its success in becoming the European centre for RMB bond issuance, listing and secondary market trading.

In Australia's case, while the kangaroo bond market - that is, overseas companies and institutions issuing $A denominated bonds in Australia - is quite sizeable, there is no history of companies issuing non-$A denominated bonds here.

Against such a background, what are the prospects looking forward for building up both primary issuance in and secondary market trading of RMB-denominated bonds in Sydney? Again three factors are worth considering: potential future issuers in Australia of RMB-denominated bonds (i.e. supply); possible future demand for RMB-denominated fixed income assets; and infrastructure and market support. Looking firstly at the supply side, the most likely potential issuers in RMB are probably Australian banks with a significant presence in mainland China; Chinese banks with a local presence; and companies in Australia that need RMB for investment or working capital purposes. While at present, as noted earlier, direct investment in China by Australian companies is not large, it is likely to continue to grow as both the volume and diversity of Australia’s trade relationship with China expands. However, as China’s capital controls are further relaxed and its capital markets deepen, Shanghai itself is likely to become the major centre for raising RMB capital, a point discussed in Part One of this paper.

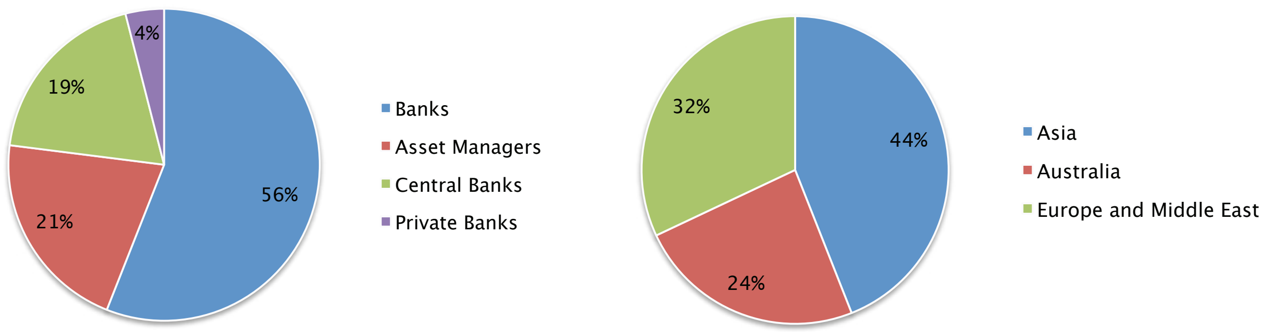
Another way of looking at this is to consider countries in which Australian companies have very large levels of investment, such as New Zealand, the U.S. and the UK. When such companies have needed to raise capital in the currency of the countries in which they are invested, they have typically done so in those countries rather than in Australia, because it has been easier and cheaper to do so. As China’s markets become more open, sophisticated and liquid, the same will be true of Australian companies investing in China, and also Chinese companies engaging in direct investment offshore in RMB. Over time, Shanghai is likely to become the global centre for RMB capital raising. Indeed, in late September 2015 it was announced that Bank of China (Hong Kong) and HSBC were given approval to become the first foreign banks to issue RMB bonds in mainland China.

On the demand side, again banks holding RMB balances may well be one source of demand. This was the case for example with the RMB issue late last year by NSW Treasury Corporation. Figure 2.14 below shows the breakdown of investors in the T-Corp RMB 1 billion issue. With respect to the 24% of local investors, the largest category was banks.

As discussed earlier, as China becomes a key component of global benchmark indices then a potentially significant source of demand for RMB-denominated bonds is likely to be the funds management sector. However, in practice a good deal of such asset exposure is likely to be contracted out to offshore managers, and what is not may more likely be invested in larger RMB issues in more liquid offshore markets.

The third factor, namely market infrastructure, is one in which Australia is likely to be well positioned in the near future, due to the development of the Austraclear platform into a multi-currency facility and the ASX's plans to also develop a range of RMB-denominated risk management products (Box 2.4 above).

Figure 2.14: NSW T-Corp RMB Issue by Investor Type and Region



Source: T-Corp

A further relevant factor is the cross-currency swap market. T-Corp swapped their recent 1-year RMB bond issuance back into AUD, as they do with all their foreign currency issuance. For issuers looking to do this for longer duration bonds, the at times limited liquidity in the cross-currency swap market for longer tenor transactions in particular may be a constraint and disincentive. This is yet another example of the "chicken and egg" problem with respect to market liquidity: the more issuance there is in Australia in RMB, the more efficiently and competitively the cross-currency swap market can operate; but to get increased issuance here you need, at least for some issuers, an efficient and competitive swap market first.

Equities

Many of the comments above with respect to the difficulties in building up RMB-denominated fixed income business in Australia also apply on the equities side.

It can take years for Chinese companies - particularly private companies as against state owned enterprises - to obtain a listing on China's equity markets. While the authorities have attempted to reduce the backlog and time taken, it can still be a very slow process: there are some 1200 companies in China waiting to list; and local turnover is low. This has encouraged some companies to look to list elsewhere, such as in Hong Kong, Singapore and the U.S.. The ASX has also encouraged Chinese companies to list here, but progress has been slow: 19 Chinese companies are currently listed on the ASX compared to 16 companies two years ago.[97]

An Australian based company, Asia Pacific Stock Exchange (APX), was set up specifically

97 Source: ASX.

to attract Asian listings and to take advantage of this backlog of Chinese companies looking to list and encourage listing here. The company has its own exchange licence but does not have its own clearing or settlement licence: this is done through the ASX's CHESS system.

The APX exchange commenced operation in March 2014 with two listings. A third listing occurred in July 2015, and a number of further listings are likely over coming months. These companies are listed in $A; while the longer term objective of APX is to enable companies to list, trade and settle here in RMB, this will need to wait on ASX's further development of Austraclear into a multi-currency platform for equities as well as fixed income, which is expected to take some years (see box 2.4 above). APX is also looking at some other options that may facilitate listing and trading in RMB or at least price quotation in RMB in the shorter term.

There are a number of reasons why progress has been slow. It is costly for brokers to connect to new exchanges; there are regulatory barriers to brokers connecting to exchanges that that do not have access to clearing systems; stricter listing rules here than in some other jurisdictions act as a disincentive for some companies, even allowing for the lower market capitalisation and shareholding spread requirements at APX than at the ASX; China is starting to develop lower-tier exchanges for listings of companies that have found difficulty in getting listed on its main exchanges; and local turnover is low. APX are hoping, through working with another company owned by their parent company, to overcome some of these problems by linking up with overseas brokers in Hong Kong and mainland China.

As mentioned earlier, encouraging companies to list in Sydney that have been unable to list elsewhere may also run the risk of "adverse selection", in the sense of attracting the wrong sort of companies. Some years ago, Singapore actively encouraged Chinese companies that were having trouble listing in mainland China to list on the Singapore exchange. The policy was on one level successful; however, the quality of some of the companies that did list was questionable, and in a number of cases Singaporean investors lost considerable money, leading to something of a backlash and change in policy.

Conclusions

Over time, more Chinese companies are likely to establish a base in Australia and more Australian companies will do the same in China. In addition, as China becomes a major component of benchmark fixed income and equity indices, demand for RMB-denominated assets will increase significantly.

These developments provide scope for increased RMB-related capital markets activity in Australia, facilitated by the ASX's development of its Austraclear platform into a multi-currency clearing mechanism.

However, progress in this area is likely to be slow, due in particular to lack of local liquidity and ongoing competition from other centres - including increasingly Shanghai - where liquidity is greater.

CHAPTER SEVEN: Engagement with China

Looking forward, growth in RMB-related business in Sydney will depend on a number of factors, including importantly growth in Australia's trade with China; growth in the proportion of trade that is settled in RMB; and market access in China for Australian financial services companies, including commercial banks, fund managers and insurance companies.

As mentioned in Chapter Two, one potentially important advantage Sydney has over many other offshore RMB centres is the recent negotiation of ChAFTA. An important aspect of ChAFTA with respect to financial services is that it provides mechanisms for negotiation of additional market opening measures going forward. If Sydney is to take full advantage of its appointment as an official RMB centre, it is important that these mechanisms for discussing further market opening measures down the track need to be used as effectively and efficiently as possible. This is the focus of Chapter Seven.

Official Dialogues with China

Australia now has in place a number of structures for ongoing dialogue with mainland China on issues relating to our strategic and economic relationship. The main ones are:

- Annual Leaders Dialogue. This is between the Australian Prime Minister and the Chinese Premier. It can cover a broad range of strategic and economic issues, including potentially financial services;
- Annual China-Australia Strategic Economic Dialogue. Put in place in 2013, this is between the Australian Treasurer and Trade Minister and the Chair of China's National Development Reform Commission (NDRC). Its primary focus is trade and direct rather than portfolio investment, reflecting the NDRC's major areas of responsibility;
- Annual Foreign and Strategic Dialogue between Foreign Ministers; and
- Biannual Financial Services Committee (FSC) meetings. The FSC was established under the ChAFTA and is scheduled to meet every two years: its first meeting may not be until December 2017 assuming the ChAFTA is ratified in December. On Australia's side, it consists of Treasury; The Department of Foreign Affairs and Trade (DFAT); and APRA, ASIC and the RBA as required. On China's side it will be attended by the Ministry of Commerce and the key regulators as required, including the PBOC and SAFE. Its remit is to supervise implementation of the financial services annex in the FTA, including market

access issues, and to facilitate 'cooperation in emerging areas of commercial interests as China pushes ahead with economic liberalisation and reform'[98]

The existence and remit of this FSC is a reflection of a commitment on behalf of both Governments to ensure that, in the financial services area, the ChAFTA is a dynamic and evolving agreement rather than a static one. The FSC seems likely over time to become an important body for discussing further access and ease of access to each other's financial markets. Its deliberations and work agenda may well feed into discussions and negotiations at a ministerial level through the other dialogues, although at this stage just how these various dialogues might interconnect remains to be determined.

Representation on the FSC is confined to the official sector: there are no private sector representatives. While it is highly likely that, assuming ChAFTA is ratified, the FSC will have its own Secretariat, our understanding is that no decision has yet been made on this or on the composition of the Secretariat.

If the opportunities arising from China opening up its capital markets and from Sydney's appointment as an official RMB hub are to be grasped, Australia needs to continue to actively negotiate with China on market access and related issues. The China/Australia Free Trade Agreement and the associated establishment of the Financial Services Committee both provide an ideal mechanism for doing this and - equally importantly - demonstrate China's willingness and desire to do so. Australia needs to take full advantage of this opportunity and also be open to consideration of policy changes that China may seek.

A point that was stressed by a number of contacts in both the official and the market sector in preparing this report was that, if such negotiations are to work effectively, a mechanism needs to be put in place that provides sensible and well-considered proposals from the financial services sector, for the consideration of the FSC and the Federal Government and for possible use in the high level dialogues.

The lack of such a body when market feedback was sought following the signing in November 2014 of a Declaration of Intent with China was seen by a number of contacts as significantly weakening the usefulness of that market consultation process leading up to the June 2015 signing of ChAFTA.

The need for a body to provide filtered and sensible feedback to the official sector in the context of the ChAFTA is mirrored with respect to our recent trade agreements with Japan and South Korea. In all three cases, mechanisms are in place for ongoing negotiations regarding market access, including with respect to financial services; but no mechanism is in place for discussing relevant issues between the Australian financial services sector and the official sector.

98 DFAT (2015)

The need for an official/market sector body to liaise on financial services policy issues more broadly - including importantly *domestic* policies impacting on cross-border financial flows - has long been recognised. The recommendation for such a body in the 1997 Financial System Inquiry (Wallis Inquiry) led to the establishment of the Financial Sector Advisory Council in March 1998. However, it is widely recognised that the Council does not provide an effective forum for market consultation, filtering of ideas and proposals or formulation of sensible and workable policy changes[99]. This was what led the 2009 Johnson Report "Australia as a Financial Centre", to propose a new body, the Financial Centre Task Force, which was in fact established in 2010 but disbanded in November 2013 due to budget constraints[100]. The 2014 Financial System Inquiry in its Interim Report also raised the issue of whether such a body was needed, in particular in relation to providing "economy-wide advice to Government about Australia's international financial integration"[101] but for unknown reasons did not have any specific recommendations in this area in its Final Report.

Chapter Nine sets out a recommendation on this important issue. Just how such a body might be structured and how it might interact with other, broader financial services advisory bodies should the recommendation be accepted is a matter for key stakeholders. Appendix 2.5 outlines a possible framework.

Given the pace and uncertain direction of financial services policy change in China, a further requirement for productive ongoing negotiation with China on market access and related issues is official sector resources on the ground in China that can keep in touch with the thinking of government and regulators on future market opening initiatives and provide early "litmus test" feedback on the viability of desired policy changes. This could complement and assist discussion within the Financial Services Committee.

Australia has considerable official sector representation in China. The Government agencies primarily responsible for contact with the official sector in China are DFAT, along with the Treasury and RBA representatives in China. The NSW Government also has trade and investment staff in Shanghai, Guangzhou and Chengdu. Austrade has staff in 10 cities in China, focused primarily on links with the corporate sector. In the negotiations and completion of ChAFTA, these various agencies worked closely together, in part acting as a "sounding board" on relevant policy issues.

Given the Financial Services Committee's focus on further mutually beneficial financial market opening measures, seem to be considerable merit in ensuring that Australia's official agencies in China continue to work together and share information on financial services policy issues - including importantly with respect to sounding out policy proposals that may become part of the FSC agenda.

The above recommendation is also returned to in Chapter Nine.

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99 See on this Johnson and Weir (2014).

100 See Johnson and Weir (2014).

101 FSI (2014) p. 4-101.

NSW Delegations to China

In April 2013, the NSW Government was presented with a commissioned report reviewing its international engagement[102]. Amongst the terms of reference for the review was the following item:

"Consider the priorities for NSW businesses in terms of what most assists them to further their trade opportunities internationally".

The review set out a series of recommendations designed to ensure amongst other things effective and productive international engagement with a range of trade and investment partner countries, with China identified as one of the most important partners. It also stressed the importance of working closely with the Federal Government on initiatives such as those outlined in the " Australia in the Asian Century" White Paper, including by way of "influencing Federal Government policy levers."[103]

In September 2014, and in part flowing from the earlier report, The NSW Government published its strategy specifically for engaging with China[104]. Among the commitments were to conduct regular trade and investment missions to China; and to work with industries likely to benefit from the ChAFTA to provide support, briefings and information and partner with such industries in trade missions.

In addition, further work focused on NSW's strategy with respect to engagement with China is currently underway.

The priority given by the NSW Government to building closer trade and investment relationships with China is evident in these and other reports, and indeed in its commissioning of this report. Given the considerable resources that have been directed at NSW's engagement strategy with China and the fact that further strategic work in this area is currently underway, it has not been a focus for this report. However:

One area in which our discussions with market participants suggest that improvements could possibly be made is in liaising with industry well in advance of any missions focused on financial services, so that dates can be locked in early and there is adequate time for consultation with industry on the key issues they would like to see discussed.

There would also seem to be considerable merit in, where possible, co-ordinating Federal and State financial services missions to China. In financial services as in other sectors it is important that Australia presents a consistent and coherent message to China.

Chapter Nine contains recommendations designed to assist on this front, by greater use of a

102 NSW Government (2013).

103 Op. cit., p. 33.

104 NSW Government (2014).

revamped RMB Working Group (see next section) to act as an official/market sector conduit on these issues.

RMB Working Group and Sydney for RMB Committee

In April 2013 officials and business leaders from Australia and Hong Kong met for the inaugural Australia-Hong Kong Renminbi Trade and Investment Dialogue. This official sector led annual dialogue is focused on RMB trade settlement, products and offshore RMB development.

One outcome from the first Australia-Hong Kong Dialogue was the formation of an RMB Working Group based in Sydney comprised of senior representatives from the Australian and Hong Kong financial sectors, with a mandate to investigate opportunities for expanding RMB trade settlement and investment. This market-led group, with official sector observers from The Australian Treasury, Hong Kong Monetary Authority and Reserve Bank of Australia, meets periodically throughout the year, culminating in the formal annual Dialogue.

The RMB Working Group agreed in July 2014 to develop an action plan and timeline for the launch of an Australian financial services initiative on Sydney as a centre for RMB business. This resulted in the formation of the Sydney for RMB Committee, comprising government and market representatives.

The Sydney Committee works closely with the NSW Government on positioning Sydney as an RMB hub. A notable example of this was its involvement in the Sydney Shanghai Finance Symposium held in Sydney in November 2014.

Discussions with the Chair of the RMB Working Group and the Sydney for RMB Committee suggest that, from both an efficiency and effectiveness perspective, these two bodies should be combined and the responsibilities of the new body expanded. The new RMB Working Group could be responsible for:

- *Discussing market issues relevant to building up RMB business in Sydney, across banking, funds management and capital markets;*
- *Monitoring RMB liquidity;*
- *Liaising with an offshore consultative group on cross border issues, including the annual Australia/Hong Kong RMB Trade and Investment Dialogue;*
- *Establishing and monitoring an RMB website which includes RMB activity data, relevant research and forthcoming events; and*
- *Liaising with NSW Department of Industry and potentially with the Federal Treasury and DFAT on both state and federal financial services delegation visits to China (see previous section).*

This issue is returned to in Chapter Nine.

CHAPTER EIGHT: Measuring Progress

Earlier chapters have suggested that there is considerable scope for building up RMB-related financial services business in Sydney, but also significant challenges. Looking forward, it will be important to monitor growth in RMB-related business across the range of activities discussed.

However, both from a market and a public policy perspective, data on RMB-related financial transactions in Australia are at present very limited. In some areas, the very low volumes of RMB activity have meant that, to date, separate data have not been published. Two examples are an Australian Bureau of Statistics survey in 2014 on foreign currency invoicing by Australian domiciled companies; and the RBA data on holdings of foreign currency deposits.[105] In both cases, RMB volumes were too small to be published separately.

One potential source of data on RMB transactions is the SWIFT[106] messaging data for foreign exchange transactions. However, usage of the SWIFT messaging system is not evenly spread across countries and regions, leading to geographic bias if SWIFT data are used. Nor can the data be broken down by the market where the trade was initiated. In 2011, BNP Paribas - a significant participant in offshore RMB flows - decided to start booking all of their CNH business to their Head Office in Paris. The resultant back-to-back booking process has substantially increased apparent CNH flows between BNP Paribas's Asian operations centre in Hong Kong and its Head Office in Paris, in the process artificially boosting the extent of apparent CNH business transacted through Paris.

Furthermore, a number of the larger international banks that are heavily involved in offshore RMB flows use their own internal messaging systems rather than SWIFT, adding to its unreliability.

SWIFT data also at times entail a degree - possibly significant - of double counting where there are a number of legs to a transaction. By way of example, SWIFT data record both legs of FX swap transactions as separate spot transactions, thereby overstating the market turnover data for both currencies involved in the swap[107].

One of the requirements placed on central banks in locations where there is an official RMB clearing bank is to gather data on local RMB business and send it to the PBOC. However, only a limited amount of these data are published by the PBOC or any other Chinese agency. In some

105 See Australian Bureau of Statistics "Export and Import Invoice Currencies, June 2014", Feature Article in "International Trade in Goods and Services", 5368.0, June 2014; and Reserve Bank of Australia Statistical Bulletin, Table B2: "Banks On-Balance Sheet Assets, Liabilities and Off-Balance Sheet Business".

106 Society for Worldwide Interbank Financial Telecommunication.

107 While these observations regarding the reliability of SWIFT data are based primarily on market discussions, they are also consistent with more recent comments by the IMF with respect to the reliability of SWIFT data. See IMF (2015) pp. 59-63.

offshore RMB centres, the local central bank is either already publishing, or going forward will publish some of the data gathered and forwarded to the PBOC. In the case of London, the Bank of England in August this year commenced publication of some of the data collected on behalf of the PBOC.

In the case of Australia and the RBA, this process of gathering data has begun, but the RBA want to obtain more data in order to properly assess it for accuracy and possible seasonality before they decide what and when to publish, subject to the agreement of the banks providing the data . This process may take some time.

In a number of other offshore RMB centres, agencies that are responsible for promoting the centre and encouraging greater activity also publish information from a number of sources on local RMB activity.

Both government agencies and market participants need reliable and publicly available time series data on RMB-related business. We see considerable merit in a revamped RMB Working Group which includes representatives from the RBA, Treasury, NSW Department of Industry and the financial markets, having responsibility amongst other things for ensuring that, once it is available, reliable and timely data are publicised.

Chapter Nine includes a policy recommendation along these lines.

CHAPTER NINE:
Potential Growth Areas and Policy Recommendations

The two primary objectives of this report have been to:

- Identify the most promising areas for leveraging off the establishment of Sydney as an RMB hub and building up RMB-related financial services business; and
- Examine the major constraints, both market and policy related, to Australian companies taking full advantage of the opportunities that are available.

The approach taken to tackling these two issues has been twofold:

- Visiting nine offshore RMB centres to determine the main lessons that can be learnt from what other centres are doing; and
- Talking to a wide range of domestic and offshore financial services contacts across the banking, funds management and capital markets sectors, both in companies that are already actively engaged in RMB-related business and others that are not, to identify both opportunities and constraints.

(a) Carving Out a Niche: Potential Growth Areas

With respect to the first objective above, key areas that have been identified as holding out the prospect of increased RMB-related business going forward are banking and funds management. With respect to banking, provision of trade-related RMB products and services is seen as a growth area over coming years, boosted significantly by the expected shift towards RMB invoicing and settlement of much of our commodities trade with China. Another important growth area in the banking sector is likely to be provision of products and services for Australian companies looking to invest directly into China, and Chinese companies looking to invest in Australia.

With respect to funds management, the report has examined both prospects for increased portfolio investment in China by Australian funds management companies over time and scope for Australian companies to gain mandates from Chinese investors. On the first dimension, the report has suggested that, given the size of China's economy and capital markets and its ongoing growth prospects, a substantial increase in exposure to Chinese assets is highly likely over coming years as China continues to improve its corporate governance and as its equity and fixed income markets become a large component of global benchmark indices. This increased demand for RMB-denominated assets may have some spill-over effects over time with respect to building up RMB-related capital markets business in Sydney.

On the second dimension, namely scope for raising investable funds in China, the report noted the increased activity in this area, both by larger Australian funds management companies and smaller boutique funds. However, it also noted that many companies still seem largely unaware of the pace of policy change in China and the related emerging opportunities. While the size of both private and official sector savings pools in China and the growing need to diversify their investment into offshore assets suggests that the opportunities in this area are substantial, the report has emphasised and discussed in detail the challenges that need to be overcome, both market and policy related.

Turning to scope for developing RMB capital markets business in Sydney - that is, primary issuance and secondary market trading of RMB-denominated equity and debt - the report sees more limited opportunities for growth, at least in the short to medium term. On the positive side, the ASX is broadening the scope of Austraclear so that it has the potential to clear not just trade-related currency transactions but also RMB-denominated bonds and at a later stage, equities, and a range of RMB-denominated derivative instruments. In addition, as mentioned earlier local demand for RMB-denominated assets is likely to increase significantly over coming years as China becomes a growing component of fixed income and equity benchmark indices. However, lack of local liquidity, competition from other centres such as Hong Kong, Luxembourg, Singapore and increasingly Shanghai and lack of any history of raising non-$A equity or debt in Australia are likely to limit growth prospects in this area.

(b) Removing Constraints: Observations[108] and Recommendations

Banking

Discussions with the banking sector and survey feedback from bank clients identified three constraints or potential constraints to growth in trade and investment related RMB business. Firstly, with respect to trade-related business, the two surveys conducted by the authors in their first and second reports looking at the attitude of companies to RMB trade settlement, along with market discussions and feedback, suggested that the greatest constraints to higher levels of RMB settlement in China/Australia trade lie at China's end, including:

- Lower levels of awareness amongst Chinese companies, especially SME's, regarding RMB settlement possibilities end, and;
- The feedback that some Chinese banks were also discouraging their clients from invoicing in RMB, due to loss of high margin FX business.

These RMB settlement survey results may be of interest to Chinese officials in forthcoming

108 Observations are shown in italics below

discussions, given the importance of increased RMB trade settlement to China's objective of RMB internationalisation.

Secondly, in both the banking and the insurance sectors, a number of financial institutions raised the issue of APRA's capital requirements with respect to equity investments in joint ventures substantially impacting on their competitiveness relative to many competitors from other countries. These comments were often in the context of growing business in Asia more broadly, not just in China. While the insurance sector has not been a focus of this report, it is worth noting that the larger insurance companies in Australia are somewhat constrained in their capacity to further expand their market share domestically and are looking to further grow offshore, including increasingly in Asia. However, they see their capacity to do so as constrained by APRA's capital requirements on such ventures.

RECOMMENDATION 1: APRA Capital Requirements

Australian banks and insurance companies need to be able to compete on a more equal footing when engaging in joint ventures in China and the region more generally. In line with this objective, consideration should be given to adopting the Basel III recommendation (which is applied in most other countries) and only requiring equity exposures in other companies to be deducted for capital adequacy purposes if the aggregate investment is greater than 10% of the company's own capital base.

Thirdly, a number of banks raised the importance of ensuring adequate intraday RMB liquidity in the future in the context of the expected significant growth in RMB trade settlement and the recent introduction of the new CIPS interbank payments system.

Going forward, it will be important to monitor local intraday RMB liquidity and how changing settlement arrangements impact on it. This should be one of the responsibilities of the revamped RMB Working Group (see recommendation five below)

Funds Management

This report has identified funds management as an area with significant potential for expansion over coming years, with growing Chinese investor interest in two asset classes in which Australia has particular expertise, namely real estate and infrastructure. However, it has also identified the many challenges involved for Australian companies, in particular branding and distribution within China. A number of different options that are opening up for dealing with these two constraints, are discussed in detail in Appendix 2.4.

More generally, keeping on top of the rapid pace of policy change in China and the resultant emerging opportunities is a major challenge for funds management companies. While more Australian companies are taking advantage of emerging opportunities in the funds management area, many others seem unaware of the pace of policy change in China and its implications.

RECOMMENDATION 2: Funds Management Opportunities and Market Awareness

The RMB Working Group should partner with other interested bodies, such as the Financial Services Council, to raise awareness within the funds management sector of both the opportunities and challenges in raising funds in China. This could be done by, for example, holding annual symposiums focused on:

- ***changes in China's regulatory and market access arrangements with respect to offshore fund managers; and***
- ***the pros and cons of different approaches to raising investable funds in China.***

This recommendation has the support of both the RMB Working Group Chair and the Financial Services Council.

The 2009 Johnson Report identified some major tax constraints that make it harder for Australian fund managers to raise investable funds offshore. It made a number of recommendations designed to overcome these obstacles. One of them - introduction of an Investment Manager Regime designed to provide greater tax certainty for offshore investors investing through an Australian vehicle- has recently been legislated. However, while considerable work has already been done by Treasury on a second important recommendation - introduction of alternative collective investment vehicles - progress on this issue at the political level has been delayed by moving its consideration into the Federal Government's forthcoming Tax White Paper. This also has significant implications for the usefulness to Australia of the Asia Region Funds Passport initiative, which Australia has been at the forefront of negotiating with other countries in the region and which is close to commencing on a pilot basis. In the absence of the appropriate collective investment vehicles to market to other Passport countries, Australia will miss out on the potential benefits of this important initiative.

RECOMMENDATION 3: Alternative Collective Investment Vehicles

Given its importance and the extensive work that has already been done on the issue, the Federal Government should prioritise introduction of legislation allowing for alternative collective investment vehicles that are taxed on the same basis as managed investment trusts.

One potentially important source for attracting Chinese investors into Australian funds is the Significant Investor Visa program. Some Australian companies have been establishing businesses focused on helping Chinese SIV investors to find suitable compliant investments in Australia. Resident fintech entrepreneurs and ventures could potentially be significant recipients of some of these funds. Greater awareness by Chinese investors of the investment opportunities in the fintech space may help overcome any concerns. However, NSW has been falling behind Victoria with respect to SIV applications. One reason for this, based on market feedback, is the greater commitment of resources by Victoria to both domestic and offshore marketing and support services for the program.

RECOMMENDATION 4: Significant Investor Visa Program

- *(a)* ***NSW should consider devoting more resources to marketing and support services for the SIV program, both domestically and offshore.***
- *(b)* ***Consideration should be given to including fintech representatives in NSW missions to China focused on marketing the SIV program.***

China is a world leader in some areas of fintech innovation, such as e-commerce platforms. One area where some very interesting work is underway, both in Australia and overseas, is development of cheaper and faster technologies for cross-border payments.

There would seem merit in putting fintech developments and opportunities on the agenda for a forthcoming Sydney Shanghai Finance Symposium.

Publicity, Marketing and Missions to China

Most offshore RMB centres have in place a body focused on supporting development of the centre by way of raising market awareness of RMB-related opportunities and products availability; commissioning relevant research; and publishing RMB-related data, policy updates, papers, speeches and media reports. In Sydney's case, work in this area is currently split between the RMB Working Group and the Sydney for RMB Committee.

Discussions with the Chair of the RMB Working Group and the Sydney for RMB Committee suggest that, from both an efficiency and effectiveness perspective, the RMB Working Group and the Sydney for RMB Committee should be combined, with a broader work program.

A strategic report on NSW's engagement strategy with China is currently underway, so it has not been a focus for this report. However, one area in which our discussions with market participants suggest that improvements could possibly be made is in liaising more closely with industry well in advance of any missions focused on financial services, so that dates can be locked in early and there is adequate time for consultation with industry on the key issues they would like to see discussed.

Given the volume of delegations from different countries visiting China, our Federal structure and the importance of presenting a consistent message when engaging in missions, there would also seem to be considerable merit in co-ordinating Federal and State financial services missions to China.

RECOMMENDATION 5: Role of RMB Working Group

The RMB Working Group and the Sydney for RMB Committee should be combined. The new RMB Working Group should include market representatives across banking, funds management and capital markets, along with NSW Department of Industry, Treasury and the RBA. It would be responsible for:

- ***Discussing market issues relevant to building up RMB business in Sydney across banking, funds management and capital markets;***
- ***Monitoring RMB liquidity;***
- ***Liaising with an offshore consultative group on cross-border issues, including the annual Australia/Hong Kong RMB Trade and Investment Dialogue;***
- ***Establishing and maintaining an RMB website which includes RMB activity data, relevant research and forthcoming even***ts; and
- ***Liaising with the relevant state and federal agencies to assist in the planning of, agendas for and market sector representation on future financial services NSW missions to China.***

Negotiations with China

One advantage that Sydney has over many of the 17 other official offshore RMB centres is that Australia has negotiated with China (but at the time of writing not ratified) a free trade agreement which provides a body, the Financial Services Committee (FSC), for ongoing dialogue and negotiation on further market opening measures.

In order to maximise the benefits going forward from these developments, it will be important to utilise the FSC and other official dialogues as effectively as possible. The report suggests that this will be greatly assisted by a mechanism that provides sensible and well-considered proposals from the financial services sector, for the consideration of the FSC and the Federal Government. Such a body could also provide advice to government on domestic policy issues of relevance to encouraging cross-border financial activity.

It is also worth noting that Treasury's Sydney office is looking to work with the private sector on various domestic policy issues going forward, some of which are likely to be relevant to building closer financial relations with China and other countries in the region. It would seem sensible to have the Treasury (Sydney) office represented on the proposed Task Force.

RECOMMENDATION 6: China Financial Services Task Force

We recommend that a China Financial Services Task Force (CFSTF) be established, consisting of senior financial services executives and government officials, to provide advice to the Commonwealth Treasury and through Treasury to government on policy issues, both domestic and in China, that relate to building broader and deeper financial relations between China and Australia.

Past experience suggests that, for such a body to work effectively, it would need to be serviced by a small dedicated Secretariat. It could also work in co-ordination with other bodies such as Treasury's Sydney Office and the RMB Working Group. Such arrangements would need to be developed by the relevant stakeholders. Appendix 2.5 sets out a possible structure.

Given the pace of policy change in China, co-ordination and information sharing where possible amongst the various official sector agencies in China - DFAT, Treasury, RBA, NSW Department of Industry and Austrade - on regulatory and market access changes in China's financial services sector is increasingly important. It is also important with respect to early sounding out of policy proposals that may become part of the FSC agenda.

Measuring Progress

Looking forward, both government agencies and market participants will need reliable and publicly available time series data on RMB-related business in order to monitor its growth across the range of activities discussed. While as noted earlier reliable data on RMB financial transactions in Australia are at present very limited, this will improve once some of data collected by the RBA are published. There may also be scope for publishing some market survey data.

The obvious body to do this is the proposed new RMB Working Group.

RECOMMENDATION 7: RMB Activity Data

The revamped RMB Working Group (recommendation 5) should be given responsibility for publicising reliable and timely data on local RMB activity, including both official data and, where possible, market survey data.

Implementation

Reflecting the fact that many of the key policy issues that will impact on the success or otherwise of Sydney as an RMB centre are Federal ones, the above recommendations include areas of both State and Federal responsibility. The NSW Government has long recognised the importance of working closely with the Federal Government on issues relating to international engagement.

RECOMMENDATION 8: Implementation

There may be merit in delegating officials within the Trade and Investment unit of the Department of Premier and Cabinet to take charge of following through on those policy recommendations in this report that are accepted by the State Government.

CHAPTER TEN: Conclusions

Sydney is now competing with 17 other cities nominated as official offshore RMB centres, and the competition for business is increasing. While Sydney's appointment as an official RMB hub, along with the recently negotiated free trade agreement with China, reflect well on Australia's relations with China and on the scope to broaden and deepen them, success as an offshore RMB centre must be built on underlying fundamentals and focused on areas where Australia has particular strengths and skills.

The underlying fundamentals augur very well. They centre around the complementarities between the two economies: one a significant capital importer and the other rapidly becoming a major capital exporter; one needing greater security of supply of energy and food and the other a leading global exporter of energy and food; one with a very well developed services sector and the other a rapidly growing demand for a wide range of services from its burgeoning middle class; and one with a very large pool of savings that needs to be diversified into offshore assets while the other has a large, sophisticated and well regulated funds management sector. While there are other economies that have complementarities with China, few have as many.

What particular financial services skills and expertise can Australia bring to the relationship and focus on? Our four major domestic banks are all very highly rated and all have a presence in mainland China, while all the major Chinese banks have a presence here. Our merchandise exports to China are larger than the major offshore centres of Singapore, London or Hong Kong; as they diversify and as commodities become increasingly priced and settled in RMB, the scope for growing transactional banking business focused around both trade and direct investment flows is substantial.

On the funds management side, both the competition for raising investable funds in China and the challenges, such as brand recognition and distribution, are significant. But Australia has a number of advantages. We are one of the leading recipients of direct investment flows from China, and there are already both large and boutique financial services companies working with Chinese institutional investors to help them find the right assets to invest in. Over time many of these institutional investment flows into direct assets are likely to diversify into portfolio investments, and Australia has considerable expertise in two asset classes of growing interest to Chinese institutional investors, namely global real estate and global infrastructure funds.

There are undoubtedly constraints, at both a market and a policy level, to Australia taking full advantage of these emerging opportunities. Over time, as more financial services companies become aware of the pace of policy change in China and look to benefit from them, so Australia's financial relations with China should broaden and deepen just as our trade relations have done, to the mutual benefit of both countries.

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APPENDIX 2.1:
Comparison of QFII and RQFII Schemes

QFII and RQFII Schemes

	QFII	RQFII
Eligibility	Asset management companies: ≥ 2 years of experience; AUM ≥ USD 500m Insurance companies: ≥ 2 years of experience; AUM ≥ USD 500m Securities companies: ≥ 5 years of experience; Net Assets ≥ USD 500m; AUM ≥ USD 5bn Commercial banks: ≥ 10 years of experience; Tier I Capital ≥ USD 300m; AUM ≥ USD 5bn Other institutional investors (pension, foundations, trust companies etc.): ≥ 2 years of experience; AUM ≥ USD 500m	1. Hong Kong subsidiaries of: • Chinese fund management companies; • Chinese securities companies; • Chinese commercial banks; • Chinese insurance companies 2. Financial institutions which are registered in any of the regulator approved RQFII centres or the principal place of business is in any of the regulator approved RQFII centres
Approval Process	Up to 20 working days (Status approval) Up to 20 working days (Quota approval)	Up to 60 working days (Status approval) Up to 60 working days (Quota approval)
Investment Deadline	6 months after approval	6 months after approval
Lock up Period	Pension funds, insurance funds, charity funds, endowment funds, mutual funds, government investment and monetary authorities and open-ended china fund (public open-ended funds with ≥ 70% asset invested in china domestic market): 3 months Others: 1 year	1 year (with the exception of open-ended funds who are not restricted)
Capital Repatriation	Open-ended China funds: weekly; monthly repatriation ≤ 20% of total investments as at end of previous year Others: subject to SAFE's approval; monthly repatriation ≤ 20% of total investments as at end of previous year	Open-ended funds: daily Others: monthly
Holdings	≤ 10% for single QFII holder ≤ 30% in aggregate for foreign investors	≤ 10% for single RQFII holder ≤ 30% in aggregate for foreign investors

Source: FTSE 2015 "Preparing for China's Inclusion in Global Benchmarks" May 2015

APPENDIX 2.2: Qualified Domestic Investor Schemes

China has a number of schemes which allow eligible mainland Chinese investors to invest in offshore assets. The main one is the Qualified Domestic Institutional Investor (QDII) scheme which enables approved domestic institutional investors such as banks and investment companies to invest in offshore markets through compliant vehicles. These vehicles can then be offered to individual Chinese investors. The scheme formally launched in 2006 and has undergone several revisions over the last decade. There have also been indications that a new version of this scheme, dubbed QDII2, may be forthcoming, but no formal announcement has been made.

Australia became an approved QDII investment destination in 2008. This means that Chinese institutional investors can invest in Australian-listed stocks and managed investment schemes registered by ASIC. They can also engage the services of Australian fund managers authorised by the Australian Securities and Investment Commission (ASIC) to assist with QDII investment matters[109]. ANZ has a QDII quota in China.

The regulations relating to QDII licences differ depending on who holds the licence and hence who they are regulated by. The tables below set out different regulatory requirements and investment restrictions for different institutions.

China has also established a number of other domestic investor schemes including:

- The Renminbi Qualified Domestic Institutional Investor (RQDII) program, which allows qualified investors to invest in offshore RMB-denominated products such as dim sum bonds issued in Hong Kong.
- The Qualified Domestic Limited Partner (QDLP) program, which allows approved foreign hedge funds to access capital. The program is being piloted in Shanghai and participation is subject to approval by the Shanghai Government. Different versions of the scheme have also been introduced in Tianjin and Shenzen[110].

109 ASIC 2008 media release 08-126 “ASIC welcomes agreement as real win for the market”, 16 June 2008.

110 The Shenzen program is known as the QDIE program.

a. Differences in Permissible Offshore Investments

Type of offshore investment products	Commercial bank	Trust company	Fund manager /securities company	Insurance company
Money market instruments	not clear from the CBRC[111] QDII rules	✓ (product rated as investment grade or above)	✓	✓ (issuer rated A or above)
Fixed income products	✓ (product rated as BBB above)	✓ product rated as investment grade or above)	✓ (issuer recognised by the CSRC[112])	✓ (issuer and product rated as BBB or above)
Equity products (listed on a recognised overseas stock exchange)	✓ (shares only)	✓ (shares, global/ American depository receipts and REIT[113]s)	✓ (shares, global/ American depository receipts and REITs)	✓ (shares, global/ American depository receipts and REITs)
Mutual funds (authorised by recognised overseas fund regulators)	✓	✓	✓	✓
Structured products	✓ (issuer rated as A or above)	✓ (issuer rated as investment grade or above)	✓ (no rating requirement)	✓ (structured deposits are listed as a type of permissible fixed income products under the 2007 Insurance QDII Measures)

Source: Mazzochi R, Siu M and H Flinn 2013 "QDII - An Offshore Perspective", KWM Connect, p. 4

111 China Banking Regulatory Commission (CBRC)

112 China Securities Regulatory Commission (CSRC)

113 Real Estate Investment Trust

b. Regulatory Requirements re Sources of Funds and Onshore Selling Activities

Type of QDII	Commercial bank	Trust company	Fund manager /securities company
Commercial Bank	A QDII bank may raise funds under the "offshore wealth management regime", by issuing foreign currency or Renminbi denominated wealth management products onshore.	A QDII bank's selling activities are regulated as part of a commercial bank's wealth management regime, which is subject to the CBRC[114] rules for selling wealth management products. A QDII bank must file its QDII product plan with the CBRC before launching any new type of QDII wealth management product.	A QDII bank must adopt a "suitable products to suitable clients" principle, i.e. the QDII bank will need to classify its wealth management products and clients into five risk rated categories respectively, with prohibitions on sales of complex risky products to clients without sufficient investment experience or risk appetite.
Trust Company	A QDII trust company may set up trust schemes for a single domestic investor or several domestic investors for offshore investments. Such offshore investments are made in the name of the trust company, according to the investment provisions set out in the relevant trust document. A QDII trust company must file its QDII trust scheme with the CBRC before launching an onshore trust scheme.	A QDII trust company may "repackage" the offshore investment products through trust schemes offered to domestic institutional investors or individual investors who have the ability to bear investment risks.	The minimum investment amount for a single investor (institutional or individual) is RMB1 million (or its equivalent in foreign currency). The following financial criteria apply to a "qualified individual investor" for collective trust schemes: – the individual or family financial assets must be above RMB1 million during the subscription period; or – the individual's annual income must be above RMB200,000.

114 China Banking Regulatory Commission

Type of QDII	Commercial bank	Trust company	Fund manager /securities company
Fund manager / securities company	A QDII fund manager may raise funds through the public offering of fund units and invest part or all of such funds in offshore investment products. A QDII securities company may: – raise funds for offshore investments by setting up collective schemes; or – accept investment instructions from a single domestic investor and make offshore investments according to the provisions set out in the relevant asset management agreement.	A QDII fund manager or securities company must apply to the CSRC for approval of any public offering of fund units (in the case of QDII fund managers) or setting up collective schemes (in the case of QDII securities companies). The following requirements apply to the initial public offering of fund units or funds raised through the offering of a collective scheme: – the minimum offering size is RMB200 million (or its equivalent in foreign currency) for fund units and RMB100 million (or its equivalent in foreign currency) for a collective scheme; and – the minimum number of unit holders is 200 for open-ended funds and 1,000 for close-ended funds; at least two investors must participate in a collective scheme.	No specific investment criteria for domestic investors.

Source: Mazzochi R, Siu M and H Flinn 2013 "QDII - An Offshore Perspective", KWM Connect, p. 4

APPENDIX 2.3: IMF Negotiations on the Renminbi Becoming a Component Currency of Special Drawing Rights

Special Drawing Rights (SDR's) were created by the IMF in 1969 as an international reserve asset to supplement gold and the US dollar, which were seen as inadequate to support growth in world trade and GDP. It is currently composed of four currencies – the USD, Euro, Sterling and Yen – and is exchangeable for the freely usable currencies of IMF members. It also serves as the unit of account for a number of international organisations, including the IMF.

As part of a periodic review process, a range of issues to do with the SDR are being looked at by the IMF this year, with the review due to be completed in late 2015. This includes the possibility of adding new currencies to the SDR basket, along with other issues such as the weights of each currency and the financial instruments used to calculate the SDR interest rate.

The U.S. effectively has the right of veto on any 'fundamental changes' to the SDR, as these require an 85 per cent majority vote by the IMF's Executive Board and the US has a 16.74 per cent voting share. However, decisions to change the 'method of valuation' – for example, changes to currency weights or underlying financial instruments – only require a 70 per cent majority. The IMF Executive Board, by a decision adopted by a majority of the votes cast, has the authority to decide which of the two majorities is applicable.

Inclusion of the RMB in the basket of SDR currencies would be symbolically very important in terms of signalling progress on the pathway to RMB internationalisation. It may also encourage greater use of the RMB as a reserve currency: one of the criteria for a currency to be regarded as "internationalised". For these and other reasons, China has been very actively pursuing inclusion of the RMB in the SDR basket of currencies. Such inclusion will be one of the issues examined in this year's SDR review process. Following an IMF Executive Board decision in 2000, the SDR basket consists of currencies issued by IMF members (or by monetary unions that include IMF members) that satisfy the following criteria:

- they belong to jurisdictions that have the largest value of exports of goods, services and income over the 5 year period before the year of the review; and
- they are considered to be 'freely usable'.

While the first criterion for inclusion (share of global exports) is relatively straightforward, the 'freely usable' criterion is less clear. Currencies do not need to be fully convertible or freely floating to be considered 'freely usable'. Rather, according to the IMF, a 'freely usable' currency is one which is both:

- widely used to make payments for international transactions (as indicated by its share of global FX reserves, international debt securities and banking liabilities); and
- widely traded in the principal exchange markets (as indicated by its share of global spot FX turnover).

The five charts below provide some indication of how China stands with respect to these indicators. There is no clear mechanism for weighting the relative importance of each indicator, and the thresholds that need to be reached for each indicator are also unclear. The IMF has stated that ultimately the determination of which currencies are freely usable requires judgement on the part of the IMF Executive Board.

China's Standing as a 'Freely' Usable Currency

a. Exports of Goods and Services (5-year averages; in percent of global total)

	2005 – 09		**2010 – 14**	
	SDR bn	%	SDR bn	%
Euro area	2138	19.8	2648.0	18.2
United States	1539	14.2	1978.0	13.6
China (includes HK and Macao)	872	8.1	1613.0	11.0
United Kingdom	780	7.2	708.0	4.9
Japan	616	5.7	728.0	5.0
Canada	341	3.1	394.0	2.7
Korea	296	2.7	465.0	3.2
Singapore	269	2.5	401.0	2.8

b. Official Foreign Currency Assets (shares in percent of global total)

	2013		2014	
	SDR bn	%	SDR bn	%
USD	2701	61.3	2961.0	63.7
EUR	1041	23.7	978.0	21.0
GBP	187	4.2	190.0	4.1
JPY	147	3.3	160.0	3.4
AUD	98	2.2	98.0	2.1
CAD	87	2.0	92.0	2.0
RMB	29	0.7	51.0	1.1
NZD	11	0.2	11.0	0.2
CHF	10	0.2	11.0	0.2

c. International Debt Securities

	2010 – Q1	2015 – Q1
	%	%
USD	31.3	43.1
EUR	48.3	38.5
GBP	10.3	9.6
JPY	3.3	2.0
CHF	1.7	1.4
AUD	1.3	1.3
CAD	1.4	0.9
RMB	0.1	0.6

d. International Banking Liabilities (shares in percent of global total)

	2010 – Q1	2015 – Q1
	%	%
USD	47.7	51.1
EUR	34.4	29.7
GBP	6.6	5.4
JPY	3.3	2.8
CHF	1.8	1.7
Other	6.3	8.3

e. Global Foreign Exchange Spot Market Turnover (5-year averages in percent of global total)

	2010		2013	
	US$ bn	%	US$ bn	%
USD	1188	39.9	1691.0	41.3
EUR	691	23.2	754.0	18.4
JPY	300	10.1	612.0	15.0
GBP	213	7.1	227.0	5.5
AUD	111	3.7	196.0	4.8
CAD	78	2.6	93.0	2.3
CHF	92	3.1	84.0	2.1

Source: IMF 2015 "Review of the Method of the Valuation of the SDR – Initial Considerations" tables 2, 4, 6, 5 and 10.

APPENDIX 2.4:
Alternative Mechanisms for Accessing Chinese Sourced Funds

Reflecting China's commitment to opening up its financial markets as part of the move towards RMB internationalisation, the mechanisms by which offshore fund managers can potentially access investable funds in China is increasing. Indeed, as was noted in Part One the pace of policy change in this area is accelerating.

The main mechanisms for accessing Chinese investors are as follows:

- By winning mandates directly from Chinese institutional investors, such as China Investment Corporation (CIC), State Administration of Foreign Exchange (SAFE), or the National Social Security Fund (NSSF), or managing offshore assets on a sub-advisory basis for Qualified Domestic Institutional Investor (QDII) licence holders in China such as banks or mutual funds;
- Through entering into a joint venture (JV) with a Chinese financial services company;
- By setting up a Wholly Foreign Owned Enterprise (WFOE) in China. Up until recently, a WFOE was only allowed to engage in advisory work, consulting and research in China: it could not manage money or distribute funds management products directly. However, in mid-2015 there was an important change in what foreign companies can do in the funds management space in China. This change, which came about through the annual *US-China Strategic and Economic Dialogue*, means that wholly foreign owned financial services companies can now hold a securities trading licence in China which enables them to engage in a wide range of funds management activities, including operating a funds management platform. At present this change appears to apply only for distribution to high net worth and institutional clients, not to retail clients through a mutual fund; and
- By selling Hong Kong domiciled mutual funds into mainland China from Hong Kong, through the Mutual Recognition of Funds agreement between the two jurisdictions.

Each of these mechanisms, and some of their pros and cons, are examined below.

(a) Direct mandates

Two of the most promising sources of institutional funds for offshore foreign investors to date have been CIC and the NSSF. CIC publishes very little information on its external mandates. Following some poor early investment decisions, it conducted a review of its performance and in its 2012 report discussed a new "endowment model" approach, which resulted in higher allocations to alternative asset classes including hedge funds, private equity, infrastructure and real estate. In 2014, 26% of CIC's global investment portfolio was in "longer-term investments", namely direct investment, private equity, real estate, infrastructure and commodities, while another 12% was in hedge funds and other "absolute return" funds[115]. Market discussions suggest that this increased allocation to alternative assets has gone hand-in-hand with a higher allocation to external asset managers with expertise in these asset classes.

The same is true for the NSSF. Of the 38 overseas mandates handed out to date by NSSF, the bulk - particularly the earlier mandates - are in equities, such as global, US, Hong Kong, Asia-Pacific and emerging market funds. A much smaller number are in global and emerging market bond portfolios. More recently, however, there have been more multi-asset mandates and a number of active global real estate mandates, including one managed by AMP Capital.

Of the various large institutional sources for external mandates, the NSSF arguably provides the greatest opportunities given China's objective of establishing a national pension system. It was also the pioneer with respect to external mandates. Funds from some other pension schemes are likely to be transferred to NSSF in the near future, which could also add substantially to its size. NSSF has now had three rounds of external manager tenders; market contacts suggest the process is very transparent.

Managing mandates for bodies such as CIC or the NSSF on a fully discretionary funds management basis is clearly an attractive option, usually requiring less of a presence in mainland China – at least for the highest profile global managers. Partly for that reason, the competition for such mandates is enormous: in 2006, some 106 of the biggest global names in funds management submitted bids for the first set of NSSF external mandates; 25 were shortlisted; and 12 were awarded. While the tender and selection process was reportedly highly professional and transparent, in the absence of a well-recognised global brand name just getting in front of such institutions is not easy. Nor, however, is it impossible, as demonstrated by AMP's success in winning a mandate from NSSF to manage a global REIT portfolio. AMP's success is perhaps a good demonstration of the value of having a longstanding presence in China and a history of senior level contact with some of the key regulatory bodies and decision makers - as well as, crucially, a good performance history and high rating of its REIT capabilities.

In addition to a direct mandate from institutions such as CIC or NSSF, an offshore manager may also manage portfolios on a sub-advisory basis or via an investment manager agreement for a Chinese mutual fund, bank or other body holding a QDII licence. This may assist with both branding and/or distribution, but again establishing the contact with and trust of the Chinese distributor is not easy.

115 Source: China Investment Corporation (2014) p. 33.

(b) Joint Ventures

There are many joint ventures (JV's) operating in China's funds management sector. A 2014 report by Oliver Wyman suggested that, of the 90 Chinese mutual funds (or fund management companies (FMC) as they are referred to) then in operation, 48 were JV's with foreign asset managers, with foreign shareholdings ranging from 10 to 49%, the statutory upper limit.[116] However, it is also worth noting that, according to the same report, more than one-third of these 90 FMC's were loss-making.

Gradual market liberalisation has broadened both the type and number of FMCs. By way of example, in January 2014 the first licence was granted to a Chinese insurance company, China Life, to set up a new mutual fund or FMC, which it did in partnership with AMP Capital. More broadly, market liberalisation has seen FMC affiliate with banks, securities firms and trust funds as well as insurance companies.

A recent variation on the traditional JV is to set one up in a free trade zone (FTZ). Experience to date suggests that, while the offshore participant in such a structure cannot sell financial products to Chinese clients outside the FTZ, it can provide products and investment advice to branches of other local financial institutions located within the zone who can then offer these products to their clients outside the zone. It will be interesting to see if this approach takes off in the Shanghai and other free trade zones.

The advantages of operating via a JV in China are obvious enough, so long as the right partner has been chosen. One of things foreign partners generally negotiate into a JV agreement is that the foreign shareholder will have first right to manage international assets via any QDII licence obtained by the Chinese partner. As these quotas allowing Chinese investors to invest in offshore assets are expanded and liberalised, having such a clause as part of a JV agreement may prove to be increasingly valuable for overseas fund managers.

Teaming up with a Chinese company that is a well-known name with a wide distribution network can also solve the two biggest market hurdles for Australian fund managers looking to do business in China - namely, brand recognition and distribution. Foreign domiciled funds are not permitted to get onto mutual fund distribution platforms in China, unless they do so by way of the Mutual Recognition of Funds (MRF) agreement between China and Hong Kong. Distribution of funds management products in China has traditionally been the domain of the large banks, but this can be very expensive and their trade settlement times can be slow. This may be one reason why Chinese banks are under growing competition from other distribution platforms: in recent years, distribution regulations have been relaxed, so that now for example futures companies, trusts and insurance companies can also obtain licences to sell mutual funds. However, in each of these cases getting onto distribution platforms, for example by way of the Hong Kong/China Mutual Recognition of Funds, may prove difficult for overseas companies.

116 Oliver Wyman (2014) p. 8.

In addition, since 2013 there has been very rapid growth in e-commerce business in China, including distribution of funds. Indeed, China has proved a world leader in e-commerce, including the use of mobile based open architecture distribution platforms, which are taking an increasing share of the market. Offshore fund managers focussed on China will increasingly need to take this into account. Initially this was primarily money market funds, but more recently it has also involved mutual funds distributed by way of mobile-based open architecture distribution platforms. Alibaba earlier this year launched their Ant Fortune fund supermarket smartphone application, which will offer clients some 900 funds available by way of a simple link-up to their Alipay mobile payment platform. With widespread knowledge of their massive client base, companies such as Alibaba have the capacity to offer tailored products to very large numbers of potential investors.

More conventional forms of distribution can be extremely difficult and expensive for overseas companies without a local partner. Establishing a significant physical distributional presence in China, for example, may mean setting up in 50 or more large cities.

Some of the potential disadvantages of entering into a JV in China are also well known, particularly given the fact that it is at present not possible to have a majority stake in a funds management JV. Firstly, as a minority partner there is obviously the lack of ultimate control. Secondly, there is the risk that the Chinese partner will extract as much intellectual property as possible from the foreign partner and then look to exit the partnership. Thirdly, entering into a JV will typically require a Mandarin speaking team to service the relationship. This is less of an issue for large funds management companies but more so for boutique fund managers.

Many of the largest and best known global funds management companies are not willing to invest in JV's, due in particular to lack of control as a minority partner and concerns about losing proprietary intellectual property. Underlying this view, in some cases at least, may also be an unwillingness to accept different approaches to running a financial services business, including cultural differences. Operating a successful JV in China, or in any other Asian country for that matter, requires investing a lot of time into building trust; showing respect for cultural differences and different ways of doing business; working within the Chinese regulatory system and getting to know the regulators; and not trying to impose foreign systems and approaches on the local partner. It also requires, critically, finding a partner with a similar business culture and closely aligned goals.

While attention has focused on the withdrawal of a few foreign companies from FMC JV's in China in recent years, the reality is that many have proven to be reasonably robust.

Would a change in regulations allowing foreign companies to own a majority stake in JVs be a substantial plus? There are some indications that such a change may occur soon. A majority stake may be preferable in the case of a JV with a smaller Chinese company, but some Australian companies may see better value in a having smaller stake in a JV with a very large company, such as AMP Capital's JV with China Life. Also majority JV's can be very expensive to run.

(c) Wholly Foreign Owned Enterprises

Wholly foreign owned enterprises, or WFOEs, have been allowed in China since 1986. Initially they were primarily in the manufacturing area and used by offshore companies to set up manufacturing capabilities in China, and also trading companies. More recently they have expanded to the services sector, including financial services. The first financial services WFOE would appear to have been GIC, in June 2002.

A "negative list" sets out activities which WFOE's are prohibited from engaging in, but this list has over time been relaxed. A recent example of this has been the establishment of a number of offshore hedge funds associated with the awarding of the first batch of Qualified Domestic Limited Partner (QDLP) quotas (see Appendix 2.2) in 2013 and the second batch in March 2015.

There have also been a number of WFOE's set up in the Shanghai Free Trade Zone (SFTZ). A recent example was BNP Paribas, which registered BNP Paribas Investment Partners (Shanghai) as a WFOE in the zone in December 2014 to complement its joint venture with HFT Investment Management and introduce BNP's investment management capabilities to a range of institutional investors in China.

In addition to the general advantages of operating in a free trade zone, such as easier remittance of funds offshore, a potential advantage of establishing a WFOE in the SFTZ is that the Shanghai Free Trade Zone's Intellectual Property Tribunal, which commenced operations in April 2015, may provide greater confidence in the protection of intellectual property for foreign companies, although just how this court will operate in practice remains to be seen.

Regulatory "grey areas" in China, along with at times uncertainty as to which regulator is responsible for particular activities, have meant a certain lack of clarity as to just what WFOE's can and cannot do. However, as noted earlier, a critical recent policy change which has received less attention than it warrants has been the decision by China's regulators to formally allow fully foreign owned asset managers in China. At the time of writing, it would appear that a fully owned funds management business in China under these new arrangements can access institutional and high net worth investors, but not the retail market.

The most often quoted advantage of a WFOE is that it provides protection of intellectual property. It also allows for employment of both local staff and foreign employees. It is also easier to establish or terminate than is a JV.

Its obvious disadvantage - in particular compared to a JV - is that it does not directly solve the two biggest hurdles for many foreign companies, namely local distribution and brand recognition. However, there is plenty of scope for a funds management WFOE to enter into a JV or a commercial partnership with a Chinese company with respect to distribution, joint branding, marketing and/or sales. Different companies will have different approaches to these issues. The change in regulation opens up enormous possibilities.

Hong Kong/ Mainland China Mutual Recognition of Funds

Mutual recognition agreements between two countries attempt to make it easier for financial services companies licenced and registered in one jurisdiction to sell their products in the other jurisdiction. The success of such arrangements is far from guaranteed: Australia and Hong Kong have had a mutual recognition agreement since 2008, yet to date not one company has utilised it, in either direction. Success typically requires a fair amount of "regulatory equivalence" or similarity of regulatory requirements and procedures, between the two jurisdictions, because regulators are often very reluctant to simply accept another country's set of regulations if they are substantially different- especially if they are perceived as providing lower levels of consumer protection.

The Hong Kong/Mainland Mutual Recognition of Funds (MRF) scheme has been operational since 1 July 2015. A key factor behind its successful launch was the substantial amount of political support from senior levels of the Chinese Government.

The rules regarding eligibility requirements, application procedures and operational requirements for Hong Kong domiciled funds seeking registration in mainland China were set out on 22 May 2015 by the China Securities Regulatory Commission (CSRC). Some of the key eligibility requirements and restrictions for Hong Kong funds seeking CSRC registration are worth summarising, since they are relevant to the scheme's strengths and weaknesses.[117]

A Hong Kong registered fund seeking CSRC registration for distribution in mainland China must, amongst other requirements:

- Be established and publicly distributed in Hong Kong;
- Have at least a 12 month track record; and
- Have at least RMB 200 million or foreign currency equivalent under management;

In terms of operational restrictions:

- The fund must not be primarily invested in the mainland Chinese market. The CSRC has given guidance that this means mainland Chinese assets must not exceed 20% of the fund's total assets;
- The value of shares in the fund sold to mainland Chinese investors must not be more than 50% of the value of the fund's total assets;
- The fund must not delegate any of its investment management activities to entities in any other jurisdiction (although it may appoint an "investment advisor" in any jurisdiction); and
- The fund must not have been the subject of any major regulatory action by the Hong Kong

117 For more detailed information on the regulatory requirements relating to the MRF scheme, see Siu, Flinn and Shek (2015).

regulator, the Securities and Futures Commission, in the previous three years, or since its date of inception if that is less than three years.

The types of funds eligible under the MRF regulations are equity funds, bond funds, balanced fund, and index funds such as ETF’s. Gold ETF’s, listed open-ended funds, fund of funds, structured funds and guaranteed funds are currently not eligible.

The Hong Kong fund must appoint an appropriately qualified agent, approved by the CSRC, to represent it in mainland China. Eligible agents include asset management companies, banks and securities companies. The agent is responsible for, amongst other things, exchange of information between Hong Kong and mainland China; and fund distribution. Eligible distributors - who may be the mainland agent - include commercial banks, securities companies, futures companies, insurance companies or independent fund distribution companies.

There are currently some 100 or so funds in Hong Kong that would appear to be eligible for MRF.[118] The quota for the program was set at RMB 300 billion in each direction.

What are the pros and cons of using the MRF agreement to access investors in mainland China?

One of the potential advantages is regulatory certainty and familiarity for funds that already have a presence in Hong Kong: issues such as investment activities, custodial arrangements, fund valuations and taxation will continue to be regulated under Hong Kong law. It is just the sale and distribution of the fund that must comply with mainland law and will be regulated in mainland China.

Another potential advantage is speed to market: the whole idea of a mutual recognition agreement is to make it easier and faster to distribute products in another jurisdiction once you are registered and licensed in your home jurisdiction. However, it remains to be seen how this pans out in the case of the Hong Kong/China MRF: the CSRC in August 2015 confirmed that the period between application and approval could take up to six months.

As with other avenues for selling products into China, brand recognition and distribution remain key issues. Offshore fund managers with well recognised brands, track records in asset classes of interest to Chinese investors and a distribution in mainland China - for example, through an existing JV in China - are likely to be the key winners. For such companies, the MRF provides a fast-track way of leveraging their existing capabilities into the Chinese market.

118 Source: Liang (2015).

This general observation was if anything confirmed by the CSRC announcement in August this year of the initial seven Hong Kong domiciled fund managers who had made applications under the MRF to sell into mainland China. With one exception, they were all large fund managers with well-known names in China and a mainland joint venture. The products were primarily focused on Asian assets.

For companies that in principle would like to use this mechanism but do not have a presence and track record in Hong Kong, establishing such a presence and getting at least one year's strong investment performance can be expensive and time consuming.

APPENDIX 2.5: Possible Framework for Proposed China Financial Services Task Force

The proposed China Financial Services Task force (CFSTF) should be chaired by a senior financial services executive or recently retired executive with considerable experience in China. Further membership could consist of:

- Four senior executives from companies actively engaged in China or looking to do so, with considerable experience collectively in the commercial banking, investment banking, funds management and insurance sectors;
- senior officials from Treasury (including the Head of Treasury's Sydney office) and DFAT as ex officio members, along with the RBA, ASIC and APRA as required; and
- the Chair of the RMB Working Group.

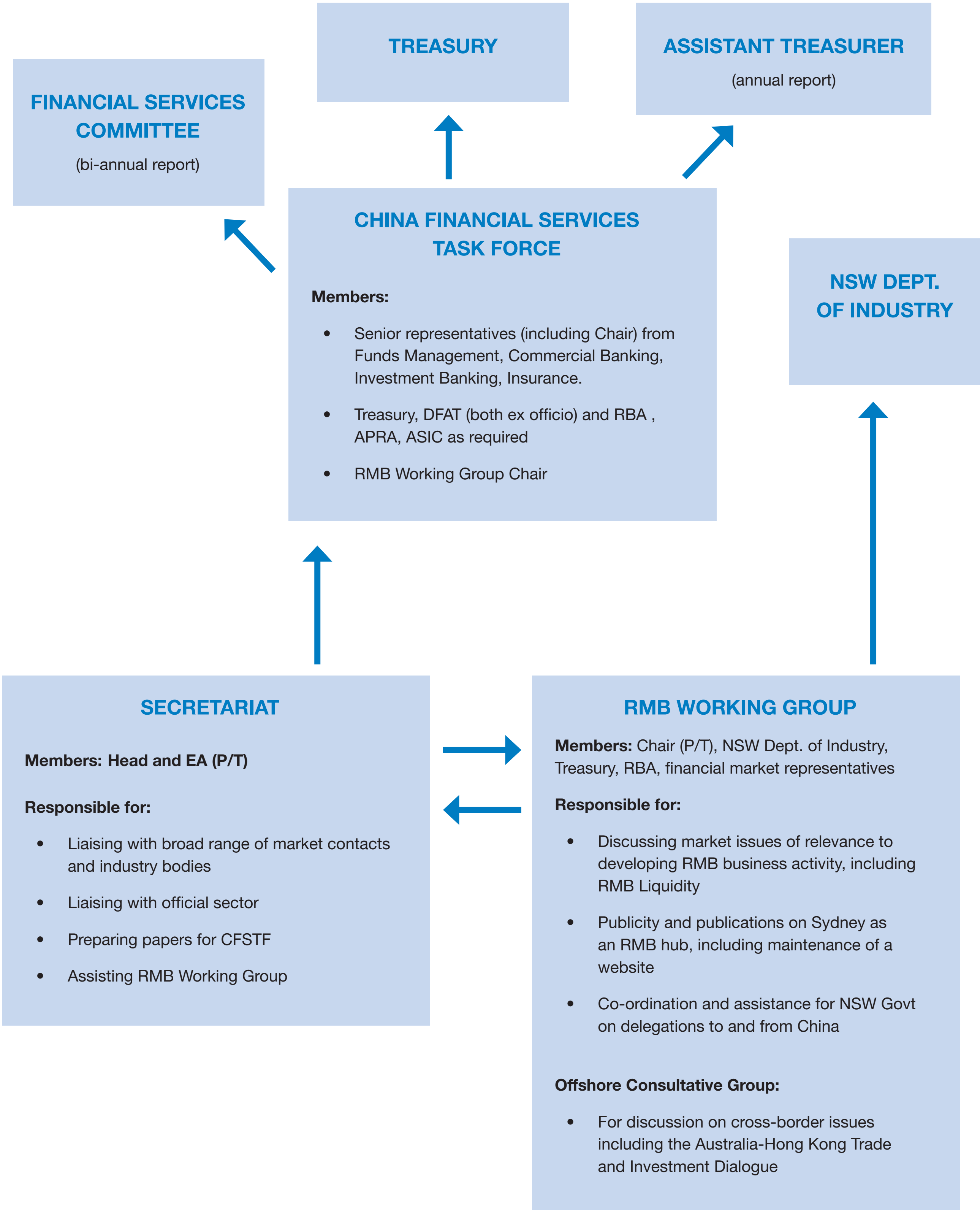
The CFSTF could report to the Deputy Secretary, Markets Group, Treasury. It could prepare annual reports for the Assistant Treasurer on progress on domestic and Chinese policy issues relating to cross-border financial relations with China. It could also prepare a bi-annual report for the Financial Services Committee on policy issues relating to implementation of the financial services annex in the FTA, including market access issues, and how to progress further market liberalisation on a mutually advantageous basis.

The Chair of the RMB Working Group could periodically report to the CFSTF on issues being considered by the Working Group that are of relevance to the CFSTF.

The CFSTF should be serviced by a dedicated Secretariat consisting of a Director with a background and wide range of contacts in the financial services sector, and a part-time Executive Assistant. The Secretariat could be responsible for:

- widespread liaison with contacts in the market sector;
- liaison with the official sector;
- preparation of reports, in consultation with the Chair and Treasury, for consideration by the CFSTF;
- preparation of both a draft annual report to the Assistant Treasurer and a draft biannual report to the FSC, for consideration by the CFSTF ; and
- providing assistance to the RMB Working Group.

The following diagram sets out a possible structure:



APPENDIX 2.6: Organisations Consulted

Alternative Investment Management Association

Agricultural Bank of China

AMP Capital

APRA

Asia Pacific Stock Exchange

Association of the Luxembourg Fund Industry

ASX

Austrade

Australia and New Zealand Banking Group

Australia China Business Council

Australia-China Council

Australian Centre for Financial Studies

Australian Financial Markets Association

Australian Securities and Investments Commission

Australian Super

Bank of China

Bank of Communications

Bank of England

Banque de France

Basis Point

BNP Paribas

BT Investment Management

Chatham House

China Construction Bank

Citic CLSA Securities

Citic Securities Australia

Citigroup

City of London

Colonial First State

Committee for Sydney

Commonwealth Bank

Commonwealth Treasury

Consulate General of the People's Republic of China in Sydney

Deloitte

Department of Foreign Affairs and Trade

Deutsche Bank

Deutsche Bundesbank

Eight Investment Partners

Emerge Capital Partners

Enst & Young

European Central Bank

Europacifica Consulting

Europlace

Federal Reserve Bank of New York

Financial Services Council

Financial Services Knowledge Hub

Geoff Raby & Associates

GlobalRMB

Goldman Sachs Asset Management

Gresham Partners

HM Treasury

Hong Kong Exchanges and Clearing Limited

Hong Kong Investment Funds Association

Hong Kong Monetary Authority

HSBC

ICI Global

Industrial and Commercial Bank of China

Institute of Finance and Banking

Insurance Australia Group

J. P. Morgan

King & Wood Mallesons

Korea Capital Market Institute

KPMG

La Trobe Financial

Luxembourg for Finance

Macquarie Bank Group

Moelis & Company

Monetary Authority of Singapore

Moreton Bay Partners

Moody's Investor Service

MSCI

National Australia Bank

New Zealand China Council

NSW Treasury Corporation

NSW Business Chamber

NSW Department of Industry

NSW Dept of Premier & Cabinet

People's Bank of China

Perpetual

Pricewaterhouse Coopers

Reserve Bank of Australia

Securities and Futures Commission

Seoul Financial Forum

Seoul National University

Shanghai Development Research Foundation

Shanghai Research Center for International Finance

Shanghai University of Finance and Economics

Shuhou Associates

Singapore Exchange SGX

Standard Chartered Bank

State Street Global Advisors

SWIFT

The Boston Consulting Group

The CityUK

Think Global Consulting

UBS

UK Trade & Investment

U.S. Department of the Treasury

U.S. Department of State

Vanguard

Vantage Asset Management

Wellington Management

Westpac Group

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