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Trading in China – Opening the floodgates

Excerpt from The Trade Asia on the Chinese QFII and QDII programs and their impact on the markets

By Jill Wong

Tentative signs of global economic recovery have again turned the spotlight on China's booming A-share market, with the easing of regulations of the qualified foreign institutional investor (QFII) programme in late September generating much interest amongst market participants who are holding out hopes for more QFII licenses and increased quotas down the road.

The very fact that regulators have moved quickly to revive the QFII programme with the earliest indications of an upturn means the latest announcement is one of tremendous significance to foreign investors. The State Administration of Foreign Exchange (SAFE) said it may adjust the QFII quota ceiling as needed, and that reviews under the QFII programme will be more balanced going forward.

Andrew Freyre-Sanders, head of equity execution services at The Royal Bank of Scotland (RBS) in Hong Kong, says, "There hasn't been new approved QFII for quite some time. So in our situation the quota is well utilized, and if you look at the iShares FTSE/Xinhua A50 China Index ETF, it is currently trading at premium to the underlying China index, which is pretty much the best indicator of QFII demand."

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Competitive forces

On the other hand, domestic fund managers can use multiple brokers to access the A-share market. Typically, domestic buy-side firms rent 'trading seats', which essentially are rights to trade, from brokers who provide them with DMA access to the A-share market. Because of the regulation that each domestic fund manager can only place 30% of the annual trading volume of a fund through a single broker, fund managers typically require four trading seats for an individual fund.

But gradual changes in the competitive landscape are forthcoming according to Charles River Development, a front- and middle-office software solutions provider that opened its regional office in Beijing in October. Peter Sherriff, principal architect, Asia-Pacific at Charles River Development, says, "Our first domestic Chinese client went live on 22 October. The client trades A-shares as well as domestic bonds on the Shenzhen and Shanghai exchanges and the interbank OTC markets.

"It has been a strategic focus of ours for the past 18 months to two years to get the domestic clients to use us for their domestic business, rather than just looking at the qualified domestic institutional investor (QDII) business. Obviously, the QDII business is a relatively small amount of the assets that these companies manage and the domestic business is the key one for us to get into."

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Evidently, local fund managers' interest in QDII, which permits investment by Chinese institutions in offshore markets, has paled in comparison to A-share products. Dong Wang, head of special projects at HSBC Jintrust Fund Management Company in Shanghai, the local joint venture of HSBC Global Asset Management which had assets under management of US\$1.4 billion as of end-June 2009, says, "If you are a fund manager, you really have to think hard about what kind of products you want to launch because the A-share market is doing well, and probably the easy choice will be to launch an A-share fund rather than to try a QDII fund. Normally with-in one year, you would only have two new funds approved so you have to decide very carefully whether you want to launch a QDII product or a local product. But because the A-share market has been performing quite well since the last quarter of last year, everyone is busy launching local products now.

"Then you have to think about the renminbi appreciation issue because the long-term trend is one of appreciation against all major foreign currencies, and all the returns that you can expect from foreign-currency-denominated assets will have to be translated back into renminbi. In that sense, I would say the present environment favors local equity products.

"In November 2007, investors were really enthusiastic about investing over-seas, then when the financial crisis happened a lot of the funds' net asset values went down to something like 30-35 cents to the dollar. In recent months, investors have gradually recovered their previous losses but, in terms of their overall interest, I think it still takes time to rebuild their confidence level. "

A single solution?

By offering a system with A-share dealing capability, Charles River is effectively moving into a space monopolized by Hundsun Electronics. Currently, Charles River's system is effectively a portfolio management platform for locally-traded securities, while clients continue to use Hundsun's system as a direct gateway to the exchanges. But according to Sherriff, Charles River is developing a direct gateway to the Shanghai and Shenzhen exchanges, the interbank market and the China Financial Futures Exchange.

Wang adds, "Almost every buy-side fund house in China is using the system provided by Hundsun Electronics, but when you do QDII, the Hundsun system cannot support investing in overseas markets because the overall trading environment is totally different. Joint ventures with foreign partners that have trading capacity would normally just utilize their foreign partners' in-house systems.

"The challenge for domestic fund managers in China is that you really have to manage two distinctly different trading systems, one for local A-share dealing and one for over-seas investments. In the longer term, it will not work because we don't see anywhere in the world where you maintain different systems for different markets.

"Because the China market is opening up with the QFII to allow foreign investors to invest in the A-share market and the QDII to allow local investors to invest in overseas markets, the overall trading infrastructure in China will have to converge to inter-national standards. In terms of the capacity of the stock exchanges to process trades, they are

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already on very high standards inter-nationally. They provide DMA to all participants and settlement is electronic and STP. So in that sense we are already there. But to accommodate foreigners and foreign fund managers and to enable them to access the local market directly, the local trading environment may need to change in some small areas to be fully compliant with international standards like FIX.”