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Subject SAFE Scraps Investment Quota Restrictions for QFII and RQFII

I. Introduction

On September 10, 2019, the State Administration of Foreign Exchange (SAFE) announced to abolish the investment quota restrictions for the Qualified Foreign Institutional Investors (QFII) and Renminbi Qualified Foreign Institutional Investors (RQFII).

According to this announcement (SAFE Announcement September 10, 2019), QFII and RQFII will only need to register to remit funds independently to carry out securities investment in the future.

In practice, abolishing QFII and RQFII investment quota means three aspects: Firstly, the total investment quota of QFII and RQFII is abolished; Secondly, the filing and approval of the quota of each QFII and RQFII is abolished; Thirdly, the pilot regime of RQFII countries and regions is abolished, financial institutions of any country and region can apply to be a QFII or RQFII.

SAFE, by abolishing the investment quota regime, aims at increasing China's financial markets attractiveness for foreign investors.

Currently, there are three Chinese authorities who are involved in the QFII and RQFII regulatory regime: **People's Bank of China (PBC)** is mainly responsible for the promotion of RQFII pilot countries and regions; **China Securities Regulatory Commission (CSRC)** is mainly responsible for QFII/RQFII qualification access and investment management; **SAFE** is mainly responsible for QFII/RQFII Investment quota and exchange management.

The above announcement means the current regulatory framework of QFII and RQFII systems will be adjusted. SAFE stated that it will immediately proceed to amend the "Regulations on Foreign Exchange Administration of Domestic Securities Investment by Qualified Foreign Institutional Investors" (SAFE Announcement No. 1 of 2018) and other relevant regulations.

II Comments

The development of QFII and RQFII system

The QFII system refers to the qualification system for foreign professional investment institutions to invest in China. The QFII system is a transitional system in which a country introduces foreign capital and opens up capital markets in a limited manner if the currency is not fully convertible and the capital account is not yet open. Such a system requires that when foreign investors enter a country's securities market, they must meet certain conditions to become QFII. Only after the approval of the relevant departments of the country, QFII can get a certain amount of foreign exchange funds and convert to local currency to invest in the local securities market, through a special account of strict supervision.

In 2002, China implemented the QFII system, allowing a certain amount of foreign exchange funds to enter the domestic market and be converted into

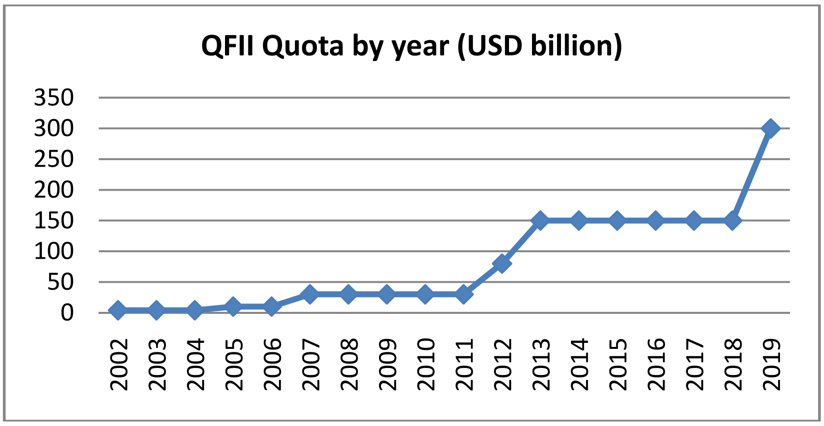
RMB, and investing in the mainland securities market through a special account of strict supervision and management.

In 2011, the implementation of the Renminbi Qualified Foreign Institutional Investor (RQFII) system is a development and supplement to the QFII system, allowing overseas RMB to invest in the mainland market and accelerating the internationalization of the RMB;

In 2013, RQFII and QFII investors were allowed to formally enter the interbank market, opening a new era for the opening of the interbank bond market;

In 2016, the QFII and RQFII investment restrictions were further relaxed. Foreign-funded financial institutions can directly invest in the Chinese A-share market through the QFII and RQFII systems, which was aiming at increasing further international influence of China's capital market.

With regard to the quota, since 2002, the QFII quota has experienced five relaxations, from only USD 4 billion to USD10 billion, USD30 billion, USD80 billion, USD150 billion and USD300 billion in 2005, 2007, 2012, 2013 and 2019 respectively.



With regard to the number of QFII and RQFII and their respective investment, as of the end of August this year, 292 QFII institutions had a total foreign exchange investment amount of 111.276 billion US dollars (out of total quota of the year 300 billion US dollars), and 222 RQFII institutions received a total investment of 693.302 billion yuan RMB (out of total quota of the year 1.94 trillion yuan RMB).

Impact of removal of the QFII and RQFII system

In the past 17 years, the QFII and RQFII systems played a positive role in introducing overseas long-term investment into China's capital markets and promoting their healthy development during this transitional period and gradual opening-up.

After 17 years of gradual and regulated opening of its capital market, China finally abolished using quota to control foreign investment in the financial market. It can be read as the will of Chinese regulators to further opening up to attract more foreign financial investments. On the other hand, while market liberalization seems to step ahead, new sophisticated surveillance measurements are being introduced in order to increase control over the market players.

Furthermore, from the practical point of view, once the relaxed QFII and RQFII system is implemented, it will offer convenience for financial institutions. It is expected that with the new system, a QFII or an RQFII which has been granted quota will not be limited to any quota, therefore will be able to invest any fund and offshore Renminbi that it holds in mainland China's securities markets. And for financial institutions that have not yet applied for QFII or RQFII quota but are considering doing so, it is expected that the application process will be revised to reflect that it is no longer an application to obtain quota but rather to register as a QFII or an RQFII investor. Foreign financial institutions are expected to be more incentivized to join the QFII and RQFII system.

However, it is worth noting that the QFII quota to some extent becomes redundant in terms of stock investment since a cross-border investment channel known as the Stock Connect was established in November 2014. The Stock Connect program allows foreign investors to buy and sell equities in Shanghai and Shenzhen stock exchange, as well as for mainland investors to transact in Hong Kong-traded stocks. Unlike the QFII and RQFII systems, Stock Connect programs allow investors to buy stocks without requiring QFII or RQFII licenses and quotas granted by CSRC and SAFE.

The first Connect programme was between the Shanghai exchange and Hong Kong market, and it quickly expanded to include the Shenzhen exchange, and now the London exchange. Similar channels have been established for bonds, and then commodities. The below table showed how the Stock Connect program is different from the QFII system in terms of eligibility, investment scope and convenience.

	Shanghai-HK Stock Connect	**Shenzhen-HK Stock Connect**	**QFII**	**RQFII**
Eligibility criteria for participants	No	No	**Fund houses:** More than US$10 billion in assets under management; five years' experience **Banks:** The world's top 100; more than US$ 10 billion in assets **Insurers:** More than US$10 billion in assets under management; 30 years' experience	Overseas subsidiaries of China's financial firms
Investment scope	568 Shanghai A shares	880 Shenzhen A shares	A shares and bonds	20% in A shares and 80% in bonds
Trading currency	Yuan	Yuan	US dollars	Yuan
Investment quota	Daily quota of 1.3 billion	Daily quota of 1.3 billion	Quota of US$50 million to US$800 million for each firm	Combined quota of 270 billion yuan

	yuan	yuan		
Lock-up period	No	No	**Closed-ended funds:** Three years **Non-closed-ended funds:** Allowed to export 20 per cent every three months	Six to 12 months

Source: SCMP Graphics, HKEX, CSRC

In summary, although abolishing quota of QFII and RQFII is a welcomed development by all interested parties, in the short term, it may not show immediate increase on the investment value via QFII and RQFII. However, together with other reforms in the Chinese financial market, abolishing the quota, in the long run will certainly attract more overseas funds to the Chinese A-share market.

Further reforms are expected

Up until now, the market value of foreign held domestic stocks only accounts for 3.8% of the total market capital in China. The market value of foreign-held RMB bonds in China accounts for 2.2% of the total market value of bonds. This is far less than foreign held securities in developed economies. For instance, in Taiwan and South Korea, the ratio of foreign held stocks in the stock market is around 30%-40%. Therefore, it can be seen that there is still a large room for the increase in the scale of QFII investment in China and further reforms in the QFII and RQFII system would be expected to increase the investment ration of QFII in China’s financial market.

Other reforms in China's capital markets were already in full swing since last year to call for more international capital to Chinese financial market.

- In June 2018, China A-shares was officially included in the MSCI Index, bringing renewed attention to China's capital markets and attract more foreign capital to the A-share market
- In January 2019, S&P Global Ratings receives first-of-its-kind approval to enter China domestic bond market from PBOC and National Association of Financial Market Institutional Investors (NAFMII). S&P Global Ratings (China), is a wholly-owned subsidiary of S&P Global in Beijing. This is the first official approval for a foreign company to conduct credit rating business in China, which will help international investors better understand China's capital markets and achieve better risk control.
- POBC had announced that, from April 2019, RMB-denominated Chinese government securities and policy bank bonds are progressively included in the Bloomberg Barclays bond index, one of the world's three core bond indexes, with completion scheduled within 20 months. Once completely included in the global composite index, Chinese yuan RMB bonds will become the fourth largest denomination of bonds subsequent to the US dollar, the Euro and the Yen. This will play a more important role in promoting the international recognition of China's bond market, a boost to further

allocation of yuan RMB assets.

- Earlier 2019, CSRC published a consultation paper on the QFII and RQFII systems and as part of that consultation proposed allowing Wholly Foreign Owned Private Securities Investment Funds (WFOE PFMs) to seed their domestic PRC funds with QFII and RQFII quota. Although the 10 September announcement did not make reference to the implementation of this change, but since the quota has been abolished, it is anticipated that this will be introduced in the near future.

III. Conclusion

We believe that the abolition of QFII and RQFII investment quotas reflexes both the domestic and the international market demand. While in the short run, there might be no outstanding volume of foreign capital rushing into China's financial market, such policy relaxation is consistent with China's financial market opening-up reforms, and it will further simplify management and facilitate operation of QFIIs and RQFIIs. If the reform takes effect gradually, more and more QFIIs will access the Chinese market in the long run. On the one hand, it will further expand the new landscape for foreign investors in China's financial market; on the other hand, China's financial market would benefit from the added international development experience.

Wenfei will pay continuous attention to the results of the SAFE Announcement (September 10, 2019), and follow up and analyze the regulatory adjustments and impact of the QFII and RQFII system, as well as any new opening-up policies on China's financial market.

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