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Will the Chinese market welcome foreign investors?
Reasons for the Focus on Future Reforms

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The Chinese stock market is currently attracting attention among investors worldwide. This is casued by China's frequent reforms to welcome investment from abroad to the domestic stock market through gradual deregulation. On the other hand, due to China's recent depreciation in the stock market has strongly reminded foreign investors that China's stock market was under its government control. As a result, they are now reluctant to invest to the Chinese stock market. Will the Chinese government continue systematic reforms in order to welcome foreign investors? This article examines the possibilities for stock market reform in China while reviewing the path that the Japanese stock market has gone through to realize the current globalized market.

1. Current situation of the Chinese market

In order to invest in Chinese A stocks,[1] foreign investors used to need special instruments, such as QFII[2] for investments denominated in a foreign currency and RQFII[3] for investments denominated in RMB. However, since Shanghai-Hong Kong Stock Connect was launched last November, foreign investors have been able to trade Shanghai stocks through Hong Kong. To

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[1] RMB denominated stocks of Chinese companies listed in the Shanghai or Shenzhen stock markets in China

[2] Qualified Foreign Institutional Investors, QFII, is a scheme to approve certain foreign financial institutions that fulfill certain conditions to invest in Chinese A stocks on an approval basis, which was introduced in December 2002 as a pilot program. Though there is a maximum limit on the investment amount for each institution, the scheme enabled foreign investors to indirectly invest in the China market through financial instruments issued by certified QFII institutions.

[3] Renminbi Qualified Institutional Investors, RQFII, is the "RMB version" to the QFII system. Originally, the scheme was only applicable only to the Hong Kong branches and subsidiaries of the securities companies in Mainland China. However, since March 2013, investment was approved for foreign financial institutions in Hong Kong and the restriction on the investment target was also lifted. Furthermore, the investment quota is also allocated to other places, such as London and Singapore.

follow this initiative, there is also an undergoing plan to launch Shenzhen-Hong Kong Stock Connect by the end of this year, further increasing the methods for foreign investors to invest in Mainland China stocks

However, there is also some bad news. Stock prices have dropped sharply in the Shanghai market since mid-June. During the time, the Chinese government intervened in the market excessively to control stock prices. There was also a system that enabled listed companies to halt transactions of their own stocks. Such special measures have made an impression with Western investors that the Chinese market continues to be a highly distinct market. Hence, an increasing number of Western investors have kept their distance from the Chinese market due to concerns over declining liquidity resulting from such distinctness, as can be seen in the announcement made by MSCI, the American stock index provider, to exclude the Chinese A stock from an international emerging market stock index.

Does this mean that Western investors are no longer passionate about the Chinese stock market? Based on our experience, the actual measures to transfer the Chinese stock market from an emerging market to a world-leading market is yet to come.

2. Past case of the Tokyo market

Currently, the Tokyo Stock Exchange is regarded one of the most penetrated global markets even among all the developed markets as can be proved by an over-30% foreign investors' shareholding ratio at the Tokyo Stock Exchange. Needless to say, the biggest reason for this is the group of globally competitive companies listed in the Japan market. Also, it is worth highlighting that the stock exchange possesses an excellent system which enables it to execute a transaction within the shortest amount of time in the world.

However, during the times when our bank started the custodian business in the 1970s,[4] the evaluation on the Tokyo market given by Western investors was that it was a distinct market with extremely low liquidity where more than 20% of the market capital was owned by domestic banks (major banks and regional banks) based on a system of cross-shareholding. Furthermore, in many aspects such as the disclosure of issuer information, transaction structure, the method of securities and fund settlement, taxation systems, and the existence of administrative guidance, etc., the Tokyo market had its unique measures that were considered common domestically but highly distinct from the Western world.

[4] Our bank is the oldest and largest custodian bank for foreign investors with the Imperial Commercial Bank (an institutional bank for the Tokyo Stock Exchange), established in 1894, being our predecessor. A "custodian bank," or simply a "custodian," refers to a financial institution that stores and manages marketable securities, receives principal, interest, and dividends, and exercises voting rights in place of its investors.

Thus, it can be inferred that the impression on the Tokyo market held by Western investors at that time is almost the same as the impression on the Chinese market as a distinct market held by Japanese investors today.

3. The start of Japanese securities system reforms

In our understanding, the timing when the Tokyo market started to grow out of its distinctiveness and shifted to the global standard dates back to year 1995, after the collapse of the Japanese bubble economy.

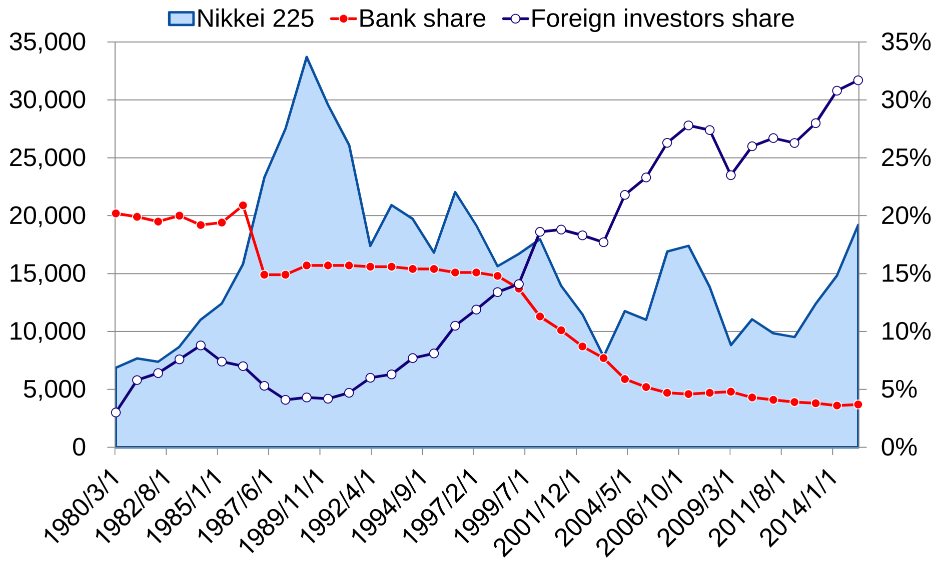
As our bank was one of the main players in the custodian business for foreign investors, we participated in various discussions related to the system reform and also received a number of individual inquiries. At that time, we were most frequently asked about how the foreign investment in Japanese stocks can be expanded. Back then, the Tokyo market had just gone through the collapse of the bubble economy, and the banks, which were the largest stockholders, were moving to remove the system of cross-shareholding. The Tokyo market was therefore seeking new buyers.

The question was delivered to global custodians in the Western market that were our customers. To our surprise, they all gave us an identical and very straight-forward answer: to adapt the Japanese securities system to one that matches the global standard. The major section of foreign investment capital is the so-called pension funds that invest on a long term. For them, the market that qualifies as a potential investment target needs to comply with the regulations of the home country. In other words, same standards with the Western world need to be applied to the method of the disclosure of issuer information, the securities settlement system (such as the adoption of DMAT and DVP settlement[5]), and the like.

Thereafter, the Japanese market went through reforms in many aspects in order to respond to the requests from foreign investors and succeeded in becoming one of the top global markets in the world. The foreign investors' stock-holding ratio has constantly been kept at the upper-20% level since the introduction of electronic stock certificates in 2009. The ratio has expanded to the 30% level since 2013. Regardless of the violent fluctuations of stock prices, foreign investors have become stable holders of Japanese stocks (Fig. 1). On the other hand, the banks' stock-holding ratio based on the cross-shareholding has shrunk to around 3%. The efforts to seek overseas buyers of Japanese stocks turned out to be successful.

[5] DVP is an abbreviation for "Delivery Versus Payment" which stands for a scheme under which the delivery of securities and the payment for the securities are mutually conditioned and one cannot be executed without the execution of the other.

Fig. 1: Nikkei 225 and the stock-holding ratio of domestic banks and foreign investors



Source: Compiled by MHBK based on data provided by the Tokyo Stock Exchange and Nikkei

4. Will an intensive system reform be carried out in China?

The Chinese authorities have been studying the Japanese systems in an extremely detailed manner. Their interest has spread into a wide range of subjects, such as the process of the Japanese bubble economy, along with the securities system and the settlement system in Japan.

We have no criterion to decide whether the current Chinese stock market is experiencing a bubble. However, the Chinese authorities are highly likely to seek new investment capital abroad following the Japanese market model if it is true that the current Chinese market is holding up prices based on the PKO,[6] as has been reported by the media.

The probability of the scenario above can be tested based on how far China will go to adopt the global standards.

Currently, to invest in the Chinese market, foreign investors need to go through either a foreign financial institution that has a QFII or RQFII qualification or through the Shanghai-Hong Kong Stock Connect from Hong Kong. Among all, for the most commonly used QFII scheme, although the qualification requirements and cap on the investment amount have been considerably loosened, there is still no change in the basic stance of the China Securities Regulatory Commission (CSRC) that carries out the qualification assessment in a centralized manner. Furthermore, the settlement system in China is highly distinct. Simply put, it is a system with a precondition that there is no fail[7] practice. The current system of the

[6] Price Keeping Operation

[7] Fail to deliver stands for an uncompleted securities settlement in DVP (Delivery Versus Payment) settlement, where marketable securities are not delivered by the settlement deadline

Chinese market, which carries out qualification assessment in a centralized manner with a precondition that there will be no failure, is designed based on exactly the same idea as that of the Japanese market before the bubble economy, i.e., when the government adopted the convoy system.

In the times ahead, if the Chinese market is in need of foreign investors, and if the Chinese market intends to continue to examine the Tokyo market to make use of the experience, the Chinese market players are expected to soon start giving convincing explanations to Western investors about their own market system.

5. To deal with the constantly changing China market

It takes time to design a system and the business practice. In addition, it is important for the Chinese authorities to coordinate closely with the financial institutions that are in charge of business practices, in order to substantiate their policies. Furthermore, for the newly designed system to be accepted by foreign investors, it will be essential to give detailed explanations to the Western global custodians who are the key players.

Hong Kong is a bridge between the Western countries and Mainland China. It is also where Western global custodians base their Asian regional hub. Therefore, those who are in charge of business practices in Hong Kong may be the first ones to recognize the changes of the China securities markets' stance toward foreign investors, allowing them to report to the rest of the world before anybody else.