China Briefing

China's capital markets: Reform, but not as we know it

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Executive summary

- *China's capital markets are still young, but have continually developed and opened up. The government seeks two positives: to allocate capital better and to gain more foreign capital and know-how. It does so abreast an unusual capital markets structure, spanning China's own systems and stock exchanges in Hong Kong and the US.*
- *China's leaders have issued a flood of recent reforms, introducing major changes that institutional investors have sought for a long time.*
- *But China starts from a very low base; as a communist country, being a "capitalist" was a deadly insult for many years. So change will come but capital must be shown as serving "the real economy". Leaders want to prevent what they call "financialisation". Outside capital will be allowed in to help the real economy grow, but high walls will be built.*
- *They also use Party techniques that are very different from classic ideas, such as strong anti-corruption pushes before a reform that removes senior executives and makes others greatly fear stepping out of line.*
- *So what comes next is likely to be accepted only cautiously by the market, no matter how radical the reform.*

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When Shanghai-based Feile Acoustics decided in late 1984 to obtain cash through the public offering of shares, local regulators were perplexed. How can you sell shares in a corporation when the state owns everything? What kind of business would it be after that? So the blockage was not in how to sell the shares — the local bank just did it over the counter — but rather, it was what to call the new entity.

Welcome to China's capital markets. Not only did China's reformers have to decide how to introduce markets, they also had to decide how to do so without losing sight of the fact that China is ruled by a capital-averse Communist Party. Barely a decade before Feile wanted to sell shares, calling someone a capitalist was a deadly insult as China was caught up in the Cultural Revolution.

So shifts came gently, often by stealth. Changes were made well before adequate legal or regulatory frameworks were in place. Dilemmas such as Feile's — *how can you be both privately and state-owned?* — were typically resolved via practice rather than by decree. Progress came in the 1990s with the Company Law (1994) and Securities Law (1999), but China's economy remained state-owned and -run.

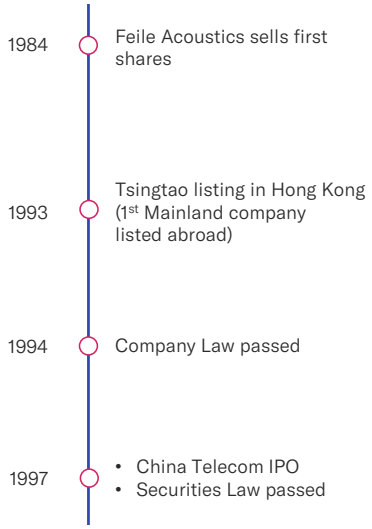
As a result, the next step was to go international. Chinese companies raised billions of dollars on international stock exchanges, mostly in Hong Kong and New York. Big oil and telecommunications companies started to list offshore through a complicated system of selling "rights" to shares of the companies, held offshore, rather than the direct shares themselves.[1] New Goliaths were created — Goldman Sachs led a USD 4.22bn IPO for China Telecom (today China Mobile), a company that did not exist eight months prior; it was created through a vast endeavour of restructuring and a national effort into something that might be listable.[2] Originally, China's telecommunications were run as an offshoot of the army and the post office. Today, the stock movements of tech giants such as Alibaba and Tencent are closely monitored across the world.

However, using money to make money remains a somewhat foreign idea in China. Given how new even having shares is, that is not surprising. But, if China wants an economy that shifts towards consumption rather than investment, or a pension system that supports the retirement of hundreds of millions of employees, or even more infrastructure, it requires capital markets. And the government is well aware of this. Expanded capital markets could assist China in dealing with mounting pressure to improve social safety nets as, at the moment, China has very few places to store and earn a return on its pensioners' retirement capital. Even if the country's high savings rate is reduced as a result of increased consumption in a more consumption-driven economy, it can be productively channelled into capital markets via private pensions and insurance, reducing the population's reliance on government programmes and domestic banking institutions.

Foreigners and their capital have been made plainly clear that they are welcome to contribute to the construction of this future through portfolio inflows. However, the question is, do they want to come? China has gone a long way from being unable to sell Feile shares — how much further must it go?

In this Briefing, the first of our series on China's capital markets, we introduce China's capital market reforms and prepare the ground for our deep dive into each of China's markets in the months to come.

Capital Markets Milestones



[1]This is a "variable interest entity" (VIE), or a way of selling shares in an offshore company that represent the actual shares of the China business.
[2]Stanton, D. (2013) 1997: China Telecom's US$4.2bn IPO: landmark privatisation. IFR 2000 issue Supplement.

Dealing with the outside world

As we hinted above while setting the scene, China's markets have some unique features. The first is that they are intimately linked to two other major markets.

The first of these is the Hong Kong Exchange. This became a major route for Chinese companies in the 1990s, when Chinese stock regulators, frustrated by their lack of purchase within the Chinese system, decided that Hong Kong offered a ready-made home for Chinese capital. (The first listing was Tsingtao, a German-founded mainland brewer who toasted their success with beer rather than champagne).[3]

Now, Hong Kong Exchange is intimately intertwined with China. Stocks include so-called "red chips" (Hong Kong companies with large operations in Mainland China), and H-shares, Chinese companies listed in Hong Kong. Hong Kong remains a very attractive site for IPOs. It offers a stable legal and regulatory system, lets one raise funds in a convertible currency, and helps move wealth offshore, which is usually impossible to do from China at scale.

The other link is a unique collaboration between the Hong Kong, Shanghai, and Shenzhen stock markets which allows international and mainland Chinese investors, without bureaucratic intervention, to buy or sell a selection of stocks or bonds in each other's markets. These Stock Connect and Bond Connect programmes have been wildly popular, especially with Chinese investors.[4] The basic rule of these programmes is that home rules apply, that is, you buy in Hong Kong using Hong Kong regulations and vice versa. There is a closed loop system: the money stays in a consolidated account. This means that there are no lock-up periods or repatriation restrictions, as opposed to buying directly onshore in China, which despite progress is still bureaucratic and limited to institutions.

The other major link is with the US market, which is in many ways China's "second" stock market. In the early 2000s, Chinese companies needed access to much deeper pools of capital. They chose to list in New York, often as American Depository Receipts ("ADRs") or shares that are actually certificates issued by American banks that represent shares in foreign stock, with that stock itself sitting in offshore jurisdictions such as the Cayman Islands, which represent ownership of the company's operations in China. This allowed a company's shares to be bought and sold in the US. ADRs are a big market — depending on the day, roughly one-third of the size of the Hong Kong market[5] — as this model has long been the way to grow fast, especially for tech companies.

ADRs and Stock Connect show the elegant pragmatism of Chinese capital markets. They brought the experience and participation of foreign institutional investors to the dynamism of China's fledgling companies. Everyone won. Major asset managers needed stability and clarity regarding rules and regulations, and the US and Hong Kong exchanges gave that to them with regard to their investments in China. This in turn allowed them access to China's booming economic growth.

But they also made life complicated for regulators and investors alike. There are three different regimes, each with their own characteristics. Firms can therefore have different valuations due to listing on different exchanges, despite having the same fundamentals.

And while the reforms boosted access, they also led to many complaints. At the start, China's high level of domestic savings made it easy to ignore the vast international pools of capital. Those within China who do not trust the world could question whether one needed to deal with foreigners. And those foreigners in return have long complained, justly, about how easy it was for Chinese firms to access global capital markets compared to foreign enterprises seeking financing from Chinese investors. (Even today, mainland China's initial public offerings are not currently available through Stock Connect, and foreign investors interested in investing in these listings must use the China onshore schemes such as QFII). For Chinese investors, there are always constraints on allocations and profit repatriation — not to mention major questions of political trust.

[3] Van Der Linde, H. (2022). *Asia's Stock Markets from the Ground Up,* p. 114.
[4] "By the end of 2020, only about 10% of the trading on this market was done by overseas investors." Ibid, p. 116.
[5] As of 6 May 2022

Today, Beijing's relationship with Washington has become deeply problematic. There are some 260 Chinese firms listed in the US. Nearly half of all ADR firms have been threatened by the US Securities and Exchange Commission ("SEC") with possible expulsion from American exchanges under a 2020 law[6] which targets foreign companies if they fail to comply with American auditing standards for three years in a row. They want to audit working papers of ADR companies, which are stored in China, but China denied the request on national security grounds.

Neither China nor the US are willing to budge on this issue. Apart from the handful of state-owned enterprises (SOEs) listed in the US, China also has a slew of large technology businesses listed on US markets. Both sets of regulators will take a firm stance against them under data privacy laws. Even if a settlement is reached, some businesses would still delist. Didi, for example, has already taken action, aided by its lack of favour with Chinese regulators, whom they snubbed while listing. The importance of the US markets to Chinese firms looms large. However, there are nearly weekly updates at present on actions to try and resolve the impasse, including meetings between top officials, changes to Chinese regulations, and promises being made to companies.

Cleaning up their own house

This standoff is another reflection of the same problem that Feile faced decades ago. China's leaders do not fundamentally know what to do about private capital, and that dilemma gets even harder when nationalism comes into play.

Here, though, we will shift focus and look at what China is doing to encourage capital markets. China's leaders are charging ahead with financial sector reform. They see it as critical for economic development. But, they want capital on their terms, and for it to flow more easily to sectors that will contribute to China's long-term economic growth — advanced manufacturing and "hard tech". Making things is good. "Financialisation", or the use of money to make money, is bad.

To illustrate, let us take a recent meeting of China's 25-member leadership group as an example. Xi Jinping led a study session on private markets. He argued that China must *"stimulate the vitality of all types of capital, including non-public capital"*. But *"it must be recognised that capital's intrinsic nature is to pursue profits...if [capital] is not regulated and constrained, it will cause incalculable damage to economic and social development."* The goal is to avoid too much use of capital markets. So Xi argued that China must *"strictly control capital market entry"* and *"improve the system and rules for [regulating] the behaviour of capital".*

Where this gets interesting is that these new rules of behaviour are actually investor-friendly. Last month saw new legislation regulating futures and derivatives, which defines standards for trading, settlement, and delivery. Additionally, the law establishes standards for futures and derivatives exchanges, clearinghouses, and trade associations.[7]

The legislation establishes a long-awaited legal framework for cross-border futures and derivatives trading, allowing the industry to attract further foreign investors. Any exchange must acquire regulatory licence before commencing operations under the new rule, but there is no overt discrimination against foreigners. Additionally, the new regulation makes no distinction between who is eligible to be a clearing participant and who is not, potentially allowing a significantly larger number of brokers to participate. It will be tremendously enticing if overseas enterprises may register.

The new regulation has a profound effect on China's capital markets. Previously, the absence of guidelines made it difficult to hedge and manage risks via derivatives. This legislation contains rules addressing the enforcement of close-out netting, a practice that enables parties to consolidate their obligations into a single net payment owed from one party to another. Netting considerably minimises credit risk. This will encourage more local and foreign end-users and financial institutions to hedge and manage a variety of risks through China's derivatives market.

[6]The Holding Foreign Companies Accountable Act (HFCAA)

[7]At the beginning of 2020, the government lifted limits on foreign ownership of futures companies and broadened the types of derivatives available to foreign investors. However, there was no derivatives regulatory environment capable of enabling effective trading, for the numerous reasons described above. All of that has changed with the new law.

This is being supplemented by additional new rules. Capital markets are a major focus of the Factor Markets Reform initiative, which began in April 2022. These will *"increase collaboration and convergence between regional equities markets and domestic securities markets"* and *"promote bond market infrastructure connection and ensure the free flow of critical elements in the bond market"*. Notably, this does not imply a complete reversal of recent policies: China is also to *"establish 'traffic lights' for capital in order to prevent uncontrolled capital expansion"*.

This further highlights China's approach: open up, but try to continue to be adamantly opposed to financialisation. We could see a similar logic in the new Derivatives Law discussed above, where new futures and option products using the law must be *"economically viable and impervious to manipulation"*. And, moreover, *"foreign futures or derivatives trading operations that disturb onshore market order or harm the legitimate interests of Mainland investors will face legal repercussions"*.

This is intended to keep all capital market activity within China. Why? Because the clause refers to "onshore market order", but these same onshore brokers that cannot be disturbed are all owned by the state.[8] You may be able to engage in foreign futures or derivatives trading, but you need to have a broker that can buy and sell in a way such that you can use the instrument. At the moment, only China's largest 40 or so state-owned corporations have such authority to be onshore brokers, and based on this language, it is unlikely that Chinese firms will be permitted to raise cash without going through these SOEs. This indicates that China desires money coming in from overseas rather than money going out.

The battle for China is twofold: this both reeks of "my way or the highway" style directives, which investors are unlikely to appreciate, and also it is very hard for outsiders to understand what is going on. Part of the problem is that China's method of stimulating reform is first to ensure that there is a rectification of what came before. This is a polite, if euphemistic, way of saying that first you send in the corruption fighters before you send in the technocrats. This is relatively unique to China.

In finance, this occurred in November last year with the announcement of a swathe of inspection teams. (These are small groups whose job is to make sure that a corruption drive is implemented, sent down directly from the very top leaders).

Many have already fallen. Some of them, such as asset manager head Lai Xiaomin may be described as losing his job for not being very good at it. Many leaked unflattering stories to the press following the demotion. (Lai's rapid execution for bribery may also have been a reason for so many stories, as if to justify the speed with which he was tried, convicted, and killed).

Others, however, were very good at their job indeed. Take China Merchants Bank head Tian Huiyu for example. Under his watch, China Merchants Bank has a market capitalisation of RMB 1.1tn, the third-most valuable lender after Industrial and Commercial Bank of China and Construction Bank. Its 17.5% return on equity is the best in industry, versus 11.6% per average.[9] All of this makes matters very confusing for outsiders: why is he being purged now? And why purge the person who seems to be very competent? Whereas under a logic of clearing the forest before replanting it, China's leaders seem not to worry about that question as much as about promoting control of the financial sector through crackdowns and legislation.

We have focused in this section on "Cleaning up your own house" on what China has done to improve its capital markets recently. One final point is how diverse China's many techniques are. From reforms sought by institutional investors to the more populist wish for strict punishments for corruption, the last few years alone have seen a gamut of measures taken. The issue for China is when these measures contradict each other, such as when a hedge fund is legally able to use a short, but is too scared to do so due to possible ramifications if the trader is accused of corruption. How change is signalled to the market is often more important than what the new position itself is.

[8]Note that this may change but at the moment "unless specifically specified by the State Council, mainland institutions and individuals trading offshore futures must place orders through onshore brokers that hold a special international business permit (Article 120)".
[9]Bloomberg data used by SCMP

What comes next?

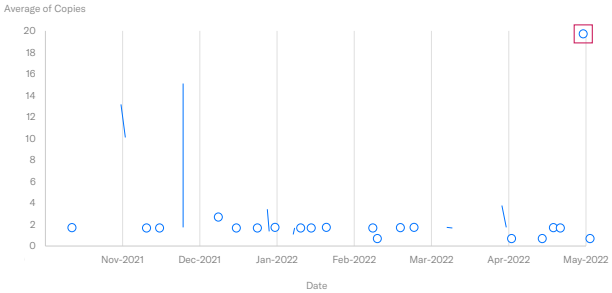
We are seeing more and more signs that China's leaders understand these tradeoffs. There has been more signalling to the market and more care taken with overseas investors in this series of reforms after the recent heavy-handed approaches taken with the Ant IPO and online education.

To show why we think this, let us look at another statement by China's leadership group, this one a "major economic and financial" briefing.

In this briefing, the Politburo discussed the tech giants, whose stock prices were hammered by the last few years' regulations. They argued that China should *"promote the healthy development and complete special rectification of the platform economy, implement normalised supervision, and introduce specific measures to support the standardised and healthy development of the platform economy".*

Why do we think that this is a sign of more investor consultation? Going by Xinhua's exact words, they are trying to "rectify" the economy — is that not just like the corruption drive we discussed above?

The reason is two-fold. First, the key verb is "complete". This is the end of a cycle, not the start. Secondly, the phrase that is significant as a signal is "implement normalised supervision".[10] This means no more surprises, which will allow for long-term capital and business planning. It is usually used for policy developments in difficult areas (food, fighting COVID), in which one should "keep an eye on changes". It is used sparsely by top leaders; chart one below which tracks the number of times the same phrase is uttered within a day in official media shows that it has been used significantly (i.e. by more than 8 leaders) three times in six months. Using it this concretely means that the very top leaders have taken command of the area, removing ambiguity.



This is a chart of how often China's top 75 official media outlets all use the same story and wording. The dots show a single day's reporting, whereas the line indicates when it is republished over multiple days. The higher the value, be it a dot or line, the more significant and coordinate the statement.

Indeed, the Politburo continued to say that China should *"respond to market concerns in a timely manner, steadily promote the reform of the stock issuance registration system, actively introduce long-term investors, and maintain the smooth operation of the capital market"*.

Yet it may not ease market concerns. Given the wobbles in China's bond market, what has widely been perceived as a regulatory crackdown on technology and fintech companies (see our Briefings on Ant and Alibaba) and China's constant adherence to the Zero-COVID policy, it is not yet clear that there can be a signal strong enough nor a framework stable enough to reassure investors. China's rules have clearly changed. China's capital markets are reforming fast, despite fears of the evils of "financialisation". The question remains who will benefit most from this — and how the government can make the beneficiaries confident enough of the changes to invest more.

[10]实施常态化监管

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