ASIA

China Lifts Foreign Investor Caps on Stock and Bond Markets

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China has long limited foreign investor access to its capital markets. However, the country recently announced it will lift restrictions, a move that further opens its markets to the global investment community. Franklin Templeton Emerging Markets Equity Portfolio Manager Michael Lai, who is based in Hong Kong, explains what this means.

China recently announced the removal of the investment quotas under its Qualified Foreign Institutional Investor (QFII) and RMB Qualified Foreign Institutional Investor (RQFII) programs, leading many to speculate about the impact on China's economy and the global investment landscape.

Increasing market access for foreign investors has been an ongoing process, as China undertakes structural reforms to its capital markets and allows foreign firms greater control over their assets.

Certainly, the lifting of these restrictions on foreign investment in China was a welcome surprise. However, we think it is unlikely to have a dramatic impact in the short term because the existing quota system was under-utilized. This being in part due to the introduction of the Shanghai-Hong Kong Stock Connect program in 2014, which provided foreign investors with a base in Hong Kong an alternative route to access the financial markets.

Nonetheless, we think the removal of QFII and RQFII quotas signifies China's commitment and long-term strategic decision to further increase access to its financial markets, a process that began in 1992 with the launch of the B shares market.

Today, China has several different share classifications. The A shares market represents Chinese companies listed on the Shanghai and Shenzhen exchanges which trade in renminbi, while B shares trade in US or Hong Kong dollars. H shares represent Chinese companies listed in Hong Kong and quoted in Hong Kong dollars. The "red chips" represent companies incorporated in Hong Kong, but whose primary business interests are in mainland China. There are also Chinese stocks that are listed on US stock exchanges, called American Depositary Receipts (ADRs).

We think this latest move to further ease foreign investor restrictions could ease some pressure from ongoing US-China trade tensions as China continues to increase market access to foreigners. This opening, on top of the recent decision to allow foreign financial firms an option to take majority stakes in joint ventures, is part of a number of encouraging announcements leading up to the 70th anniversary of the founding of the People's Republic of China.

What Are the QFII and RQFII?

> The Qualified Foreign Institutional Investor program (QFII) was established in 2002 to offer select foreign investors meeting specified criteria a way to invest onshore in China's domestic stocks denominated in renminbi, known as A shares. The RQFII program was established in 2011 and allows investors to use renminbi funds raised in Hong Kong by subsidiaries of domestic fund management companies and securities companies in Hong Kong to buy mainland Chinese stocks. There were quotas or limits to the amount of foreign investment allowed under these programs.

Impact on Foreign Investor Participation

Currently, foreign participation in China's domestic markets has been muted. Foreign investors currently own around 3% of the total domestic A-share market capitalization (cap) and 7.3% of the free float market cap.[1]

Increased foreign participation will depend on a number of factors. From a fundamental perspective, we think underlying growth and valuations will be important factors to bear. In addition, the Chinese market turbulence and stock trading suspension in 2015-2016 is still fresh in the minds of foreign investors; arbitrary share suspensions and corporate governance issues may continue to impact foreign sentiment.

Regulatory issues could still be a concern for some, and perhaps unfamiliarity with the underlying businesses in China. However, a few international brokerages have been scaling up their coverage of domestic (A shares) companies in recent years.

Other issues include limited access to a listed futures market and other derivative products that would allow investors to hedge or enhance risk management.

If we see further measures to liberalize and enhance market access that will encourage index providers such as MSCI and FTSE to increase the inclusion factor, we think China's weighting in global benchmark indexes will invariably rise, and passive funds may have no choice but to step up their purchases of Chinese securities.

While the overall immediate impact of China's move to lift restrictions on foreign investment may not be drastic, we still think it is an important signal to the investment community at large.

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1. Source: HSBC Research. Market capitalization represents the total market value of a company, and is calculated by multiplying the equity's price by the number of shares outstanding. Free-float market capitalization represents the equity's price multiplied by the number of shares readily available in the market (which excludes some shares that are not owned by public investors).