China A-shares Flash note
MSCI, see you next year for sure

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KEY POINTS

On 14 June, MSCI decided not to include China A-shares in its regional and global indices as yet. The index provider cited three outstanding concerns: (1) capital repatriation limits, (2) trading suspensions, (3) pre-approval by Chinese exchanges of products associated with an index which includes A-shares. On beneficial ownership, MSCI said improvements had been made and the issue had been resolved. It noted the commitment of the Chinese authorities, as evidenced by the progress made on onshore market reforms. The latest MCSI decision continues to signal to the Chinese authorities that more reforms are needed before the MSCI standards for inclusion are met. We note that most international investors are underestimating the speed at which reforms can be carried out in China. The progress made over the last 12 months has been significant, underscored by the rapid opening of the Chinese interbank bond market. Every step in Chinese capital markets reform is a step closer to China A-shares inclusion. So, see you next year for sure.

MSCI REJECTS THE INCLUSION NOW, BUT ACKOWLEDGES IMPROVEMENTS

As part of its 2016 Annual Market Classification Review, MSCI decided not to include China A-shares in its global, regional and country indices, but it acknowledged a lot of progress had been made over the last year and highlighted that the beneficial ownership issue had been addressed satisfactorily. Now, foreign investors can be sure that they can enjoy the benefits of ownership of onshore Chinese shares such as voting rights.

In addition, significant reforms have been introduced regarding the Qualified Foreign Institutional Investors (QFII) scheme as China has authorised daily repatriation, aligning it with the Renminbi Qualified Foreign Institutional Investor scheme. More quota access points have been given to investors such as the USD 38 billion RQFII (Renminbi Qualified Foreign Institutional Investors) quota awarded to the US. This allows the largest ETF providers to allocate to A-shares using their US entities.

WHAT STILL NEEDS TO BE DONE?

In brief, MSCI pointed out the need to:

1. **Remove the 20% limit on monthly repatriation for QFIIs**. It is important to note that despite the launch of RQFII, which offers daily liquidity, QFII rules have not been fully aligned with those for RQFII. Most of the largest foreign institutional investors and large pension funds historically hold QFIIs. MSCI highlighted the importance of seamless execution of daily repatriation as well as the removal of the 20% monthly repatriation cap as critical considerations for index inclusion.

2. **Limit the suspension of shares.** The Shanghai and Shenzhen exchanges last month clarified the rules, limiting in principle trading suspensions to three months. However, for ‘asset reorganisation cases’, halts can last longer. Of the companies in the A-shares market trading in, 57% (by market capitalisation) is suspended for this reason, according to Goldman Sachs. MSCI noted that time is required to monitor how the rules are applied before this issue can be considered resolved.

3. **Remove the requirement for the Shenzhen or Shanghai exchange to pre-approve any products linked to indices that include A-shares.** Clearly, MSCI does not want to put at risk the MSCI licensing of MSCI Emerging Market index or other indices by including A-shares.

On the next page, we summarise the views of MSCI in 2015 vis-a-vis this year’s conclusions.

Overview of MSCI 2015 concerns and 2016 comments

	MSCI concerns in 2015	Current status MSCI views in 2016	
Capital mobility restrictions	Removal of capital lock-up and repatriation restrictions on QFII/RQFII	Monthly repatriation cap of 20% of NAV remains unchanged *MSCI: "a key issue unaddressed"*	✖
	Elimination of potential trading uncertainty due to daily limit on the Stock Connect	*Not mentioned clearly by MSCI.*	
Beneficial ownership	Current QFII/RQFII framework does not provide a clear recognition on the ultimate beneficial ownership of assets under separate accounts	A-shares account system can support the recognition of rights & interests of beneficial owners of securities as held under QFII/RQFII's separate account scheme *MSCI: resolved*	✓
Widespread voluntary suspension	Widespread voluntary suspension practices prevented normal market trading and caused liquidity and replication concerns	Now trading suspension due to major 'asset reorganisation' is limited to three months. *MSCI: "A period of observation is needed"*	👁
Anti-competitive clauses	Existence of a provision that all financial products (including ETFs) linked to an index containing A-shares need to be pre-approved by the local Chinese exchanges even if listed internationally	Pending resolution by the local Chinese stock exchanges *MSCI: "(this) remains unaddressed"*	✖

Source: MSCI, BNPP IP, June 2016

ANOTHER YEAR, ANOTHER REVIEW, BUT DO NOT UNDERESTIMATE HOW QUICKLY REFORMS CAN GO

As it did last year, MSCI has explained that a 'mid-year review' would be possible. We doubt this since a lot of monitoring appears to be needed – for QFII daily repatriation practices or the suspensions. The next review is therefore likely to be in June 2017.

We believe foreign investors are underestimating the ability of the Chinese authorities to move quickly to make inclusion happen. Nobody had expected China to award RQFII to the US, but it happened. The size of the RQFII quota, the clarification of beneficial ownership as well as the relaxation of restrictions on QFII occurred in less than a year. Clearly, the Chinese authorities are willing to act to meet the MSCI standards.

The fixed-income market is an example: foreign investors can now easily access the Chinese interbank bond market. Within one year, motivated by the inclusion in the Special Drawing Rights (SDR) of the International Monetary Fund, China opened the interbank bond and the currency markets to foreign official institutions. Last but not least, since May 2016, foreign financial institutions such as commercial banks, insurers, pension funds and fund managers can access the interbank market without quota and cross-border restrictions, making it freely accessible, based on a filing system.

To conclude, the latest MSCI decision signals that the index provider feels further work needs to be done on reforms in the China equity market to make it fully accessible to foreign investors. However, the progress made to date is significant in our view and underlines the Chinese authorities' determination to succeed.

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