Going global

Trends and implications in the internationalisation of China’s currency

2017
Foreword

China’s Renminbi (RMB) is arguably already a major international currency and one growing in importance. There is much for RMB watchers to celebrate, from its recent inclusion as the fifth currency in the IMF’s special drawing rights scheme, or the addition of new infrastructure to encourage RMB investments, like Shenzhen-Hong Kong Stock Connect, or FTSE Russell’s transitional inclusion of Chinese equity into global indices.

The currency’s prominence, however, remains less than China’s share of the global economy or global trade would suggest, and depreciation since 2015 has clearly suppressed demand for RMB products. This points at the ongoing process of the currency’s liberalisation, and China’s understandable caution concerning capital flight, among other risks. China’s long-term ambitions for the RMB – as a default reserve currency and settlement for international trade – remain. But for the RMB to be successful in the next phase of internationalisation, it will need more market-driven reforms.

Interviewing over a dozen industry participants, and surveying more than 50 more for this report, we have seen a tempering of optimism towards RMB internationalisation compared with this report’s predecessor in 2015.

It is this debate about the pace of RMB internationalisation, the obstacles and what the private and public sectors can do to contribute to – and benefit from – that internationalisation, that are laid out in the following pages. We hope you find this report informative and we would like to thank those who participated for their insights and views.

Thomas Chan
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KPMG China
Context for this study

This report is the second in a series of reports on RMB internationalisation sponsored by the UK Department for International Trade and the China Foreign Exchange Trade System. Its focus is to provide an up-to-date view on the topic, with an emphasis on the opportunities, challenges and implications, as seen by those involved in international RMB products and services.

Its main source of insights was 15 interviews with industry participants. In addition, survey-based sentiment is flagged in call-out boxes and elsewhere. For more information on this report and its methodology, see the section ‘About this report’.

Note that in this report, RMB is used to denote the name of China’s currency, while CNY (Chinese Yuan), the official international currency code, is used to denote its unit of measure. CNH is used specifically for offshore RMB. 圆 and 元 are Chinese characters for Yuan, although popularly shown outside of China as ¥ (as is the Japanese Yen).
Recent developments

Volatility and depreciation against the dollar since mid-2015

China Europe International Exchange (CEINEX) launched

Cross-Border Interbank Payment System (CIPS) announced

Liberalisation of the Chinese interbank bond market (CIBM) announced, followed with a framework for foreign investment

New York granted RQFII quota

China’s Free Trade Zone coverage expands to 11 locations

UK replaces Singapore as the second largest offshore RMB clearing centre

London’s RMB-denominated bond market picks up speed, including China’s first ever offshore sovereign RMB bond

RMB formally joins the IMF’s currency basket, with the World Bank already approved as the first special drawing rights bond issuer in China, and Standard Chartered as the first such commercial issuer

Shenzhen Connect launched, adding to the existing Shanghai-Hong Kong Stock Connect

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Executive summary

There are significant differences in how China and global financial markets view RMB internationalisation (and the timescales involved).

China’s long-term ambition for the RMB is clear: RMB will one day be a, possibly the, major international trading and reserve currency. In some regards, it already is a major currency, but it remains underrepresented on a number of key metrics compared with what China’s economic clout would suggest. For example, it accounts for under 2% of international trade while RMB-denominated assets account for only 1.4% of the global investors’ portfolio.\(^1,2\)

The bridging of this ambition and present reality is a multi-year (if necessary, multi-decade) project – one that will progress at a pace determined by the Chinese authorities and not at the expense of China’s wider stability. Infrastructure like CIPS or Stock Connect are built with the long game in mind. China’s authorities often like cautious, phased roll-outs and are not put off by slow starts. Neither do they mind putting additional controls in place where they see capital flight. 2015-16’s dampening in demand for RMB products will not undermine their long-term resolve.

Markets have interpreted 2015-16 as giving relatively little evidence of China’s long-term resolve or ambition for the RMB.

2015 interventions in domestic capital markets and RMB depreciation versus the USD, consciously or not, sent a signal to global markets. Thinking on a different timescale, global markets interpreted these developments as generating major doubts concerning the RMB’s onward internationalisation. A slowed pace elsewhere, such as RQDII and QDII expansion, and tactical reversals, such as new capital controls including measures on alternative means of capital flight, like bitcoin, reinforce this view.

Just as markets had been perhaps too bullish on the pace of RMB internationalisation in the decade leading up to 2015, so they have arguably been too bearish since. This directional shift is evident in our own survey results that see a lengthening of predicted timescales before the RMB hits certain milestones.

Almost 40% (a plurality) of our survey respondents predict a fully convertible RMB with no restrictions within five years. Yet this is down from over 70% in the 2015 survey, with now more than 20% of respondents predicting that full convertibility will take over 10 years.

It is ironic that greater liberalisation (of exchange rates) has contributed to this suppressed confidence in the RMB. Depreciation has clearly driven a drop off in demand for RMB products, evident throughout this report as we review the year-on-year scale of various initiatives. Yet exchange rates clearly are transient and therefore the 2016 picture of many RMB initiatives hides the latent demand that remains unmet today. However, for China’s long-term ambition to be realised, not only will it need to drive future reforms, but it will also need to keep the marketplace engaged and enthused.

Source: 1) SWIFT, 2016; 2) PBoC, 2014
There are opportunities for stakeholders in reconciling this difference between China’s long-term ambition and market short-term perspectives.

When the RMB steadily appreciated pre-2015, holding RMB exposure in itself was enough to benefit. Now, with the RMB as a volatile currency, like any other, market players need to work harder and smarter to reap the rewards.

Consider a simplified path of RMB development in a particular country as follows:

1. **Currency swaps**
2. **Trade in RMB**
3. **Invest RMB back into China**
4. **Invest RMB offshore**

At the country level, this translates into advocating basic infrastructure, including currency swaps, forwards and futures, and ideally authorised clearing banks (for offshore hub aspirations). It also means encouraging greater use of existing corridors (e.g. in the interbank bond market), and even for those countries without offshore hub aspirations, seeing the wider benefits towards bilateral relations with China that result from being an early mover (e.g. Hungary’s 2016 issuance of RMB-denominated sovereign bonds in London).

At the fund or individual retail level globally, there remains immature levels of interest in investing in RMB (onshore or offshore). This reflects a mindset issue – a classic ‘brand recognition’ challenge – it would require investors to consider (what is to them) less known currencies and assets. Prominent initiatives, like the under-negotiation Shanghai-London Stock Connect, would also help raise this brand recognition (as well as improve the supply side).

At the institutional level, for example a UK insurer or South African importer, there is also an element of mindset at play. But perhaps more so, it reflects a lack of supporting infrastructure – relatively few banks offer sophisticated RMB solutions, which itself reflects at least three key complex and interdependent challenges for 2017 and beyond:

1. **China’s ‘big 5’** have been given a particularly key role as clearing banks in RMB internationalisation. They will likely need strategic, operational and organisational investment in order to fulfil expectations.
2. **Foreign institutions** may need to reconsider their existing mindset and assumptions, articulating what role they want the RMB and China to play in their own long-term strategies. They would also need to follow through with the required operational investments to make that happen, regardless of short-term setbacks.
3. Full circle back to our original point, and echoed throughout our interview and survey research, the private sector will benefit from greater regulatory clarity and regular communication that reassures and reconfirms China’s long-term resolve.
2016 was another eventful year, but it is worth recapping some key context since August 2015.

The new norm: exchange rate volatility
The past eighteen months have seen a consistent depreciation against the US Dollar, with three periods of notable volatility.

In the first and biggest round, China’s Central Bank, the PBoC, revised the RMB/USD central parity quotation mechanism on 11 August, 2015 – by which a number of daily metrics now inform more market-driven quotes.

- This was a significant step in RMB exchange rate reform (the last such round was in 2005).
- The mid-rate for RMB/USD is more market-oriented, the exchange rate fluctuation range is enlarged, consistency between mid-rate and previous-day spot closing price is improved and onshore-offshore spreads are narrowed.
- However, this triggered a market expectation of RMB depreciation which self-fulfilled, with capital outflows and a widening of the onshore-offshore RMB/USD spreads. Over the following 12 months, China used USD500 billion of its FX (foreign exchange) reserve to limit further depreciation.

The second round, at the beginning of 2016, was triggered by the US Federal Reserve raising the Fed Fund Rate (FFR), within the wider context of gradually decelerating China GDP growth rates.

The third round, in truth a series of events since mid-2016, has come on the back of domestic macro data, a reduced risk appetite (i.e. a return to USD) after the Brexit referendum, and then anticipated US interest rates after the presidential election.

These three rounds of volatility underline a number of points in the RMB’s path to internationalisation:
- It implies that market intervention can only maintain a rate for a limited period.
- Market participants can observe the effect of a market-centric RMB exchange rate mechanism.
- The fundamental drivers of the currency rate have become more obvious, as they are for freely traded currencies.

In the club: IMF Special Drawing Rights (SDR)
The RMB has joined a limited basket of currencies – USD, EUR, JPY and GBP – that make up the IMF’s SDR, a supplementary foreign exchange reserve asset. As of 1 October 2016, the RMB represents 10.92% of that basket, larger than both JPY and GBP shares.

This is a milestone of significant symbolic importance for the RMB’s internationalisation, joining the unofficial ‘club’ of global currencies. Practically, inclusion may also expand the demand of foreign institutions for RMB and RMB-denominated assets.

"SDR inclusion is the real beginning of RMB internationalisation.”
Carmen Ling, Managing Director and Global Head RMB Solutions for Corporate and Institutional Clients, Standard Chartered

However, the practical significance of SDR inclusion can be overstated. SDR is not used to settle trade or investment, rather IMF members can use it to swap underlying currencies, and this is more popular with developing than developed economies.

Once SDR inclusion was confirmed, the International Bank for Reconstruction and Development announced the issuance of 500 million SDR-denominated bonds in China’s interbank bond market, settled in RMB – the first issuance of an SDR-denominated bond since the 1980s. More financial institutions, such as Standard Chartered as a commercial issuer, are adding to this momentum.
Still got it: QFII relevant despite a quiet year

The Qualified Foreign Institutional Investor programme (QFII) was an early initiative to allow institutional investors into RMB-denominated capital markets, via an onshore currency swap, launched in 2003. It remains central to investors’ China strategy thanks to successive revisions, e.g.:

- Quota limit on institutions lifted, now determined as a percentage of the institution’s total assets or assets under management (AUM);
- A simplified quota application process and liberalised capital inflows and outflows;
- Capital block period cut from 12 to 3 months;
- Removal of asset allocation restrictions;
- Quota-free access to the Chinese interbank bond market, easing access to fixed-income assets (the world’s third largest bond market), and thereby encouraging lower risk players like pensions, insurers and sovereign wealth funds.

To date, over USD80 billion in QFII quotas have been granted to over 270 institutions. 2016 saw a drop-off in new quotas as market interest in a devaluing RMB cooled, but QFII’s role in RMB internationalisation will continue.

A mixed bag: RQFII yet to make a mark

Launched in 2011, the Renminbi Qualified Foreign Institutional Investor programme (RQFII) originally represented a more liberalised QFII, appealing to global investors for direct offshore RMB investment.

However, the next two largest quotas (South Korea and Singapore) represent under 50% of Hong Kong’s allocation, with a majority of actual quota use by Chinese companies based in Hong Kong.

In June 2016, a RMB250 billion quota of RQFII was granted along with a US-based clearing centre for RMB trade and investment on the back of the eighth China-US Strategic and Economic Dialogue.

Total RQFII quota granted by country as of Sep-2016, CNY billion

This gains a foothold for RMB internationalisation in the US. Quotas in themselves, however, do not equal hub status. New York’s wider offering means it remains behind Hong Kong, London and Singapore in that regard. In short, it is too soon to call to what extent US institutions will use RQFII, and what, if any, impact the new presidency will have on such initiatives to involve the US.

Total RQFII quota granted over time, CNY billion

To date, almost RMB1.5 trillion in quota caps have been set for 17 territories, but the actual amount applied and granted is closer to RMB500 billion across 10 territories. This is not some fundamental failure of the programme, but rather in large part reflects FX rates – when RMB was appreciating, there was a period when RQFII and QFII demand outpaced their quota supply.
A mixed start: Stock Connect

Stock Connect has a promising future, despite not having the start some anticipated. 2014’s launch of the Shanghai-Hong Kong Stock Connect has since seen the removal of a total quota, now operating a daily quota of over CNY10 billion in both directions, with the more tech sector-oriented Shenzhen-Hong Kong following suit (with CNY13 billion daily quotas) in December 2016.

But daily quotas are consistently underused to date, with northbound interest hit by RMB depreciation in 2016, although southbound activity has seen slight growth on 2015. Other practical barriers also exist, such as percentage caps on foreign ownership of domestically-listed companies’ shares.

Some interviewees felt that a Shanghai-London Stock Connect is likely sooner or later. They cite second mover advantage around some of the technical hurdles that Hong Kong had to design a solution for, and which London can now adopt. Secondly, they cite the relatively more balanced negotiating position (this time representations of two independent sovereign powers) that provides more of an incentive to prioritise negotiations.

"Hong Kong views a London Connect as positive competition, not a direct threat. It took Hong Kong a while to negotiate the Shanghai Connect, but there are good reasons to think a London Connect will land faster.”

Stewart Aldcroft, Senior Advisor, Citi, Chairman of Cititrust Limited

Mirror image: QDII demand up on depreciation

The 2006-launched Qualified Domestic Institutional Investor programme (QDII) allows Chinese investors to invest in foreign fixed-income products, stocks and funds. Such retail programmes have traditionally seen lukewarm demand at best, reflecting a lack of risk appetite or product development.

Yet the RMB’s depreciation and domestic market volatilities have meant an increase in secondary demand since 2015, with the original USD90 billion quota more or less fully utilised.

Trading volume under Shanghai Stock Connect, CNY billion

While authorities were not keen to encourage capital flight through further quota issuance in 2016, it is reasonable to expect further quotas in time. Furthermore, QDII mutual fund inflows are up, suggesting increased demand for offshore exposure.

Net fund flow of QDII mutual funds¹, CNY billion

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“Shenzhen Connect is a great initiative. For now, the more bridges there are, the better.”

TF Cheng, Managing Director at BNP Paribas Asset Management

Net fund flow of QDII mutual funds¹, CNY billion

Note: 1) Net fund flow of QDII mutual funds is the most direct way to see the demand for QDII; 2) Available year-to-date
Source: Wind
ETFs dominate, with bonds, asset-backed securities (ABS) and stocks also available. While CEINEX volumes remain modest at present, its development may encourage other exchanges to consider a more pro-active approach towards their Chinese counterparts. (The market is likely big enough to accommodate several more equivalents in the long-term.) Many CEINEX securities are also traded in London, benefitting both hubs. This will improve the liquidity of offshore RMB-denominated assets and products.

In its own right, London saw an uptake in 2016 of RMB-denominated bonds, with 56 issued in the first half of 2016 alone and with the total as of December 2016 standing at 103. Issuers choosing London for their RMB-denominated bonds have come from as far afield as Canada, the Middle East and Australia. Overall, RMB depreciation has meant a fall in offshore RMB-denominated assets and deposits in 2015-16, but this development is surely part of the internationalisation.

Great expectations: Mutual Recognition of Funds (MRF)

Since 2015, certain Hong Kong-based funds are permitted to sell products to mainland investors. By the end of September 2016, only 41 domestic funds and 6 Hong Kong funds were registered.

Fundraising has also been slower than may have been anticipated, with demand, especially for domestic funds, dampened by the performance of China’s stock market. Yet recent performance, with over 90% of the market represented by JP Morgan, stands out, meaning total Hong Kong investments dwarf the size of mainland fund sales.

The investment scope is widely anticipated to be expanded to include Exchange Traded Funds (ETFs, securities that track an index, bond, commodity or basket of assets, and are traded like common stock).

Choice abounds: RMB-denominated offshores

The development of RMB-denominated products has provided offshore RMB owners with more choice of RMB investment assets and hedge tools.

From RMB index funds and futures launched on the Hong Kong Stock Exchange to RMB-denominated treasury bonds issued by China’s Ministry of Finance (MOF) in London, or certificates of deposit issued by ICBC in New York, choices have increased.

In November 2015, for example, the China Europe International Exchange (CEINEX) was launched in Frankfurt, becoming a platform for trading RMB-denominated products. CEINEX trading volumes are typically around EUR3 million per day, of which around 10% is RMB-denominated.

Taking stock: the key challenges that remain

Despite these important developments, key challenges for the RMB to become truly international remain much as they were in 2014:

- Convertibility without FX instability;
- Liquidity and choice of RMB-denominated assets for global investors;
- Transaction costs for RMB trades, including ability to hedge.
RMB’s appreciation previously fuelled its demand. Global investors had a return by just holding cash.

As that trend has halted, even reversed, China needs other levers to make RMB an attractive medium of value. Here we consider both proactive attempts to stimulate RMB use, as well as the wider factors driving RMB internationalisation.

A long way up: demand results from trade

Besides investment, demand for RMB for trade settlement has plenty of room for growth.

"Trade will be the most important driver. Investment is already open.”

Carmen Ling, Managing Director and Global Head RMB Solutions for Corporate and Institutional Clients, Standard Chartered

China’s import and export volumes account for around 12% of the world’s total international trade, yet payments made in RMB accounted for closer to 2%, roughly one fifth of China’s total international trading volume. This actually represents a fall from a peak of closer to 30% of Chinese trade in 2015.

This again represents caution toward RMB-denominated trading amid depreciation, rather than fundamental reversal. Apart from difficulties in hedging RMB, underlying infrastructure continues to improve, despite an FX-driven drop in interest. In 2016, for example, the China Foreign Exchange Trade System (CFETS) launched direct trading between RMB, Korean Won and South African Rand. So far, 21 foreign currencies can be directly traded with RMB on China’s interbank foreign exchange market, encouraging RMB as a settlement currency.

If we look at a region of relatively mature trade with China, such as Europe, even within it there is a markedly different take up in RMB settlement.

Top 3 European hubs for direct RMB payment, % of European total volume

Note: 2016 available year-to-date
Source: SWIFT

Meanwhile, bilateral Currency Swap Arrangements have slowed in recent years, but by 1H16, these amounted to RMB3.3 trillion with 35 countries.

Currency swap arrangements between PBoC and foreign central banks, accumulated size, CNY billion

Note: 2016 available year-to-date
Source: PBoC

This general cool off in a range of RMB products is also clear in our survey results: for example, both onshore and offshore equities dropped in perceived opportunities, 2015 to 2016.
Latent demand for RMB-denominated trade will mean that this cool off is temporary. However, the pace of this development will depend on wider attitudes toward hedging. The additional time it takes to complete documentation to settle in RMB makes it less attractive. Then there is the link to investment – once a foreign party agrees to be paid in RMB, a challenge remains of where to invest it.

In balance? Global investor portfolios
In the longer term, a major driver will come from global institutions’ need to diversify portfolios.

China’s capital market’s capitalisation accounts for around 9% of the world’s total.1 China’s Gross Domestic Product (GDP) accounts for over 14% of the world’s total.2 And yet, RMB-denominated assets account for only 1.4% of the global investors’ portfolio.3 This reflects quite some room for growth in RMB use, relative to those benchmarks.

Regardless of asset return, the availability and accessibility of RMB-denominated assets are arguably the most important reasons why the RMB is under-allocated by global investors.

Another is the relative absence of onshore Chinese equity (“A-shares”) in global indices. FSTE Russell, for example, introduced a transitional 5% weighting for A-shares in May 2016 – on top of the roughly quarter weighting that foreign-listed Chinese companies already represented. Expect them, MSCI and others to incrementally increase the inclusion of A-shares and Chinese bonds, with some, including several of our interviewees, believing the full inclusion of bonds is likely to occur ahead of stocks.

12% of survey respondents highlighted the need for inclusion of China A-shares in indices.

Therefore, as Chinese capital markets are internationalised and global indices also play their part, we can expect a multiple times increase in RMB-denominated assets by investors.

Go West, young man: outbound deals
The Chinese government generally encourages its domestic enterprises to ‘go out’ into the world. At the macro scale this will steadily normalise RMB-denominated trade and investment.

Outbound acquisitions have become a main means for Chinese companies’ global growth. 2015 alone had over 500 outbound deals.4 Alongside the usual industries for globalisation like insurance, energy, real estate and chemicals, 2015-16 also saw a rise in technology and entertainment outbound activity.

Within financial services, insurance companies have been the most aggressive for acquisitions (in contrast, asset managers are inclined to directly set up offshore subsidiaries following the expansion of cross-border programs such as RQFII).

However, several outbound deals may have been influenced by more than just target attractiveness or strategic global expansion. Consistent with our theme around China’s long-term ambition versus short-term market signals, 2016 saw a series of new restrictions for China’s outbound companies (and individuals) in an attempt to dampen capital flight.

Grand designs: Belt and Road
‘Belt and Road’ is a key China framework, focusing on connectivity among a range of countries. It takes several forms, from cooperation on steel production capacity to the creation of the Asian Infrastructure Investment Bank, or high-profile infrastructure projects. In 2015, Belt and Road expanded to include much of central and eastern Europe. So far, it has involved over 100 countries, with signed agreements for over 30.

In RMB terms, Belt and Road influences the default currency for settlement of infrastructure projects with China. In effect, it plants multiple mini-RMB hubs along the region, and raises RMB’s prominence in existing RMB hubs (e.g. Hungary issuing RMB sovereign bonds in London).

“Belt and Road infrastructure loans to Asian countries will foster international acceptance of the RMB. There will be a paradigm shift from solely USD-based asset pricing to also RMB-based pricing.”

TF Cheng, Managing Director at BNP Paribas Asset Management

Enter the dragon: onshore capital markets

Another area for latent growth is foreign institutions’ holding of RMB-denominated assets. Onshore, efforts have been made to develop corridors as well as make existing ones more attractive. RMB-denominated fixed-income and equity assets have shown attractive risk-returns but challenges remain.

We will come back to some of the barriers to equity investment later, but consider the onshore bond market. Panda bonds (RMB-denominated bonds issued in mainland China by a non-China issuer), for example, are arguably the most liberal part of the onshore market. We have seen prominent issuances (e.g. HSBC, Daimler) and a sovereign bond from South Korea, and yet it is not particularly market driven by international standards.

The wider onshore bond market is even less market centric. Bond issuance, just like IPOs, needs approval from multiple regulators, meaning who gets to issue a bond (of how much and at what price) involves multiple stakeholders. For example, a bank issuing a financial bond in the interbank bond market would need both China Banking Regulatory Commission (CBRC) and PBoC approval. The result is that market participants see complexity, whether they are enterprises seeking financing or investors seeking exposure.

Nonetheless, development of the interbank bond market is still important for onshore capital markets in general, allowing lower risk appetite groups onshore exposure. CIBM basically opens China’s entire bond market to foreigners. It is liquid, best matches foreign institutional investors’ risk-return appetite, and it allows existing QFII usage to be swapped out from fixed-income exposure to equities.

A show of hands: offshore markets

Investment-driven demand comes with more dynamic offshore markets for RMB-denominated assets. In this regard, Hong Kong stands out, having built a marketplace for Dim Sum bonds (RMB-denominated bonds issued outside of mainland China), as well as insurance policies and gold priced in RMB.

While the other obvious choice, London, is not at that level quite yet, it is becoming a complementary Western hub for RMB given its world-leading supporting infrastructure, and its currency and bond markets in particular (for example, over 100 RMB-denominated bonds issued on London’s stock exchange by the end of 2016).

The opportunity to build a portfolio of RMB-denominated assets in London and other CNH (i.e. offshore RMB) hubs would help further internationalise the currency.

And yet, if there remains a prospect of further currency depreciation, CNH bond fundraising will remain deflated, as the 2014-15 drop-off of over 70% demonstrates.

Step by step: emerging programmes

Besides the cross-border programs mentioned already, others like the Qualified Domestic Limited Partnership (QDLP) or pending Qualified Domestic Individual Investor programme (QDIi2) will have their own merits in promoting the use of the currency. However, such programmes face the same short-term challenges, as regulators prioritise stability over further market reform.
The long game: infrastructure build

On the other hand, better infrastructure is also needed and this is where the private sector can do more (more on this later). One such example is PBoC’s Phase One of the RMB Cross-border Interbank Payment System (CIPS), announced in 2015 and connected to Hong Kong in 2016.

“The launch of CIPS was one of the main RMB developments during the past 12 months. It’s a necessary platform for both cross-border investment and trade.”
Zeyun Liu, General Manager, International Department, CITIC Bank

While 20 RMB clearing centres have been assigned globally, with CCB London celebrating clearing RMB10 trillion in August 2016, the onus will now be on banks to adjust their systems to better facilitate cross-border investment or trade, including currency hedging tools (while mindful of PBoC’s preference against hedging or arbitrage), to reduce the FX costs of trade involving RMB.

Offshore clearing authorisation is concentrated with China’s ‘big 5’ banks. Despite the first phase introduction of CIPS, RMB payments still take longer than payments in other currencies. Besides lower-than-peer automation by the clearing banks, and additional documentation needs, exact routes also differ by bank, based on processes and liquidity needs. Practical improvements in offshore hub infrastructure, and increased liquidity, could therefore be expected to boost demand.

Watch this space: Free Trade Zones (FTZs)

FTZs are pilot zones for wider infrastructure. Each of the now 11 zones has an area of focus. Shanghai is a key financial hub, so it is no surprise that its FTZ focuses on the financial sector.

The last 18 months have seen various pilot policies on convertibility of RMB under capital accounts, RMB-denominated bonds, wholly foreign-owned fund management companies, interest rate liberalisation, and liberalisation of foreign currency limits and offshore financing. What the FTZs already enable is free transfer of RMB with overseas hubs for corporates – FTZs are effectively onshore locations for the handling of CNH, providing a controlled onshore environment to deal with freely convertible and transferable RMB.

The importance of the FTZs may therefore lie in time with the financial infrastructure being built to handle RMB connectivity with offshore hubs, but for now at least, the cross-border restrictions still exist, just that they have been moved between an FTZ and the rest of the country.

China FTZs

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<td>Guangdong (includes Shenzhen, Qianhai, Hengqin, Nansha)</td>
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<td>Zhejiang</td>
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<td>Fujian</td>
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<td>Fujian</td>
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</table>

Taking stock: opportunities are longer term

As this chapter on demand drivers outlines:

- China is investing in long-term international and domestic frameworks that support the internationalisation of the RMB;

- However, these do not translate into the pace and consistency of liberalisation that global markets seek. A bearish sentiment is evident in our volume analysis of various RMB initiatives;

- This is also apparent in our survey findings, as respondents display dampened sentiment for the pace of RMB internationalisation, relative to 2015 – but China-based respondents remain more bullish on RMB’s long-term rise;

- In short, dampened demand says less about China’s long-term build and more about immediate FX rates. However, it also points to regulatory ambiguity, which we address in the next chapter on ‘Challenges’.
Sentiment on opportunities

**How long before RMB becomes…**

(2016 vs 2015 survey results, % respondents)

**Fully convertible / tradable with no restrictions, all respondents**

<table>
<thead>
<tr>
<th>Duration</th>
<th>2015</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Never</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>7-10 years</td>
<td>80</td>
<td>40</td>
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<tr>
<td>3 years</td>
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<td>60</td>
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<tr>
<td>5 years</td>
<td>20</td>
<td>30</td>
</tr>
<tr>
<td>&lt;3 years</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

**A major global investment currency, all respondents**

<table>
<thead>
<tr>
<th>Duration</th>
<th>2015</th>
<th>2016</th>
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<tbody>
<tr>
<td>Never</td>
<td>0</td>
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</tr>
<tr>
<td>7-10 years</td>
<td>80</td>
<td>40</td>
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<td>3 years</td>
<td>40</td>
<td>60</td>
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<tr>
<td>5 years</td>
<td>20</td>
<td>30</td>
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<tr>
<td>&lt;3 years</td>
<td>0</td>
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</tbody>
</table>

**The world’s most commonly used currency (surpassing USD), China respondents only**

<table>
<thead>
<tr>
<th>Duration</th>
<th>2015</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Never</td>
<td>0</td>
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<tr>
<td>7-10 years</td>
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<td>3 years</td>
<td>40</td>
<td>60</td>
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<tr>
<td>5 years</td>
<td>20</td>
<td>30</td>
</tr>
<tr>
<td>&lt;3 years</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

**The world’s most commonly used currency (surpassing USD), Rest of World respondents only**

<table>
<thead>
<tr>
<th>Duration</th>
<th>2015</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Never</td>
<td>0</td>
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<tr>
<td>7-10 years</td>
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<td>3 years</td>
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<td>60</td>
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<tr>
<td>5 years</td>
<td>20</td>
<td>30</td>
</tr>
<tr>
<td>&lt;3 years</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

Relative to 2015, overall we see a dampening of sentiment for the pace of the RMB’s liberalisation.

When it comes to whether the RMB will ever surpass the USD, an interesting contrast emerges between mainland China and other survey participants.

**Fastest-growing international RMB business areas over next three years**

(Top 5 selected from 2016 survey, ranked by popularity, with corresponding 2015 ranking)

**Top 5 answers in 2016**

1. Forex
2. Offshore institutional asset management services
3. Capital raising products/services
4. M&A advisory
5. Offshore retail asset management/wealth management services

**Other top 5 answers in 2015 that were not in the 2016 top 5**

1. Onshore equities and their derivatives in general
7. Corporate finance (cash management/transaction banking)
3. Offshore equities and their derivatives in general
10. Offshore institutional asset management services
8. M&A advisory

Forex is the strongest area of anticipated opportunity. It would appear that the market sees opportunity in the PBoC’s regulatory oversight of forex as it seeks to eliminate CNY-CNH arbitrage, but liberalisation around hedging of RMB will realistically be required before the currency can meet its FX trading potential.

Note: Further information on the survey is available in the ‘About this report’ section
Despite the drivers of RMB usage covered above, there clearly also remain a number of challenges complicating the path for the RMB’s full internationalisation.

**Comfort zone: RMB brand recognition**

At the outset of this report, we mentioned a mindset challenge – a lack of RMB ‘brand recognition’ – that restrains mainstream investors stepping outside of known currencies and assets.

Such a factor is hard to quantify. It is also interlinked with our wider point on infrastructure, as the more corridors that enable investment (e.g. Stock Connect, CEINEX), or the more prominent indices include A-shares, or the more global rating agencies penetrate China’s capital markets, the more RMB will become part of a ‘normal’ portfolio.

However, it is an important point in itself. Several of our interviewees also pointed to conservatism in RMB offshore hubs in this regard.

This is backed by relatively low levels of RMB-specific engagement on the part of relevant survey respondents.

**No unicorns: asset price volatility**

Contributing to the above point is currency and asset volatility. Internationalisation of the currency and the preceding measures to open up China’s capital account have caused a volatility that might have been seen as ‘normal’ had investors already been more accustomed to the RMB and China.

For a period, it seemed that China stood out as an emerging market with high returns on assets despite relatively low risks. But speculation around US interest rate hikes have hit many emerging market currencies, and the RMB is no exception.

We have already seen how USD-RMB volatility increased since mid-2015; likewise stock market volatility has reminded those with RMB and China asset exposure of the need for realistic assessment of the risks. It has also realistically delayed the entry of new investors not yet accustomed to RMB-denominated assets.

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**“Whether as investors or providers of infrastructure, a major challenge is the willingness of some institutions to get involved and make the necessary operational investments. From risk committee approvals to core processes, it requires a mindset change to see and invest for the long-term RMB opportunity.”**

Stewart Aldcroft, Senior Advisor, Citi, Chairman of Cititrust Limited

This is backed by relatively low levels of RMB-specific engagement on the part of relevant survey respondents.

Only 11% of respondents have specialist liaison persons for their RMB offering with either clients or with regulators.

In the following chapters (‘Solutions’ and ‘Implications’) we look at some of the steps those wanting to increase their role in RMB internationalisation can take. We also look at how China’s own ‘Big 5’ banks can play their role in overcoming such challenges.
Prepare for landing: a slowing economy

A critical issue will be the direction of the Chinese economy. Internationalisation of the RMB has capitalised on the strong growth of China’s economy and the consequent growth of demand for the RMB as well as RMB-denominated assets.

As the pace of that growth appears to enter a state of relatively stable deceleration, stakeholders may reassess the attractiveness of China exposure as well as any assets denominated in RMB.

Yet opinion is split on this. One interviewee felt that bond infrastructure was not lacking and that an investor could go to bond underwriters or brokers for analysis, and open accounts with those brokers to readily access the interbank bond market.

The equity market also faces similar debates. There are many limitations on trading, including the daily 10% upward and downward price limits of individual stocks, the restrictions on use of leverage and shorting of stocks and the lack of tools to hedge risks. Foreign participants also face different restrictions from their local counterparts, for example, a 10% ownership cap on the listed shares of a company, and a 30% cap across all foreign investors in a listed company.

Such restrictions became even more evident after the market fall in 2015 and China’s response. This finding is consistent with our survey findings on the challenges to RMB business growth.

Curb your enthusiasm: infrastructure lacking?

Despite programmes mentioned earlier, there remains a lack of wider infrastructure to support RMB currency and RMB-denominated asset trades.

For example, we mentioned CIBM. In 2015, international financial organisations, foreign central banks and sovereign wealth funds entered it with bond lending, bond forwards and interest rate swaps. In 2016, CIBM was opened to all foreign financial institutions (and their investment products) and long-term institutional investors, including pension funds. Some interviewees felt this opening highlighted a series of immediate problems, including incomplete yield curves, lack of credible information, and lack of credit rating agencies and other third-party organisations to work with.

Yet opinion is split on this. One interviewee felt that bond infrastructure was not lacking and that an investor could go to bond underwriters or brokers for analysis, and open accounts with those brokers to readily access the interbank bond market.

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Such restrictions became even more evident after the market fall in 2015 and China’s response. This finding is consistent with our survey findings on the challenges to RMB business growth.

'Restrictive regulations' remains the top challenge survey respondents identified for the second year running. 'Lack of liquidity' fell slightly in relation to a 'lack of clarity on rules and regulations' which is now the second most identified challenge.

"For a freely traded currency, investors should ideally be able to trade the currency without the quota system."

Shirley Low Storchenegger, Managing Director, Head of Asia Pacific, STOXX Limited

Then there is the risk in exposure to RMB: a lack of options to hedge currency risk limit the potential for FX trading and investment. PBoC has a preference against hedging of the currency, and although there are some ways around that, like Singapore’s Non-Deliverable Forward (NDF) contracts, these are costly and carry counter-party risk.¹

On top of this, we see the aforementioned complexity in the current RMB offshore hub clearing network, and several wider infrastructural limitations reflective of both public and private sector decisions, onshore and offshore.

16% of our survey respondents sought improved clarity of legal infrastructure related to mainland securities. Another 12% sought more offshore RMB clearing centres, and 11% sought improved clarity of company transparency in onshore financial markets. (Page 23.)

Note: ¹ PBoC regulates exchange rates and monitors FX transactions. It has previously suspended banks engaged in arbitrage, without explicitly banning the practice.

China GDP year-on-year growth rate, %

While this transition may be a prolonged or ‘soft’ landing, few players, Chinese or not, have prepared a long-term approach towards this challenge.

However, even at a lower GDP growth rate, the sheer size of China’s economy will eventually command a higher RMB allocation in all global investors’ portfolios in the long-term.

Source: China National Bureau of Statistics, annualised quarterly results
Building trust: overcoming ambiguity in communication and actions

In our executive summary we highlighted as a key theme the difference between China’s long-term ambitions and what the market perceives in the short-term. From the market point of view, there is a clear and even urgent need for a more transparent way of communicating with the regulators and government agencies.

Examples of ambiguous actions that interviewees cited include the sudden suspension of QDII quota grants, along with intervention in the stock and currency exchange markets, or more recent limits on capital outflows, both directly, and via gold and bitcoin.

Then there is the wider track record – in the financial services industry and beyond – of foreign corporate experience in China. Despite good intentions, China remains a relatively complex place to do business.

With all this said, however, there is also acknowledgement from interviewees about the multiple demands on policy-makers’ time.

“Chinese policy makers have to balance many factors when deciding foreign exchange policies: economic growth, financial reform, employment and non-performing loans.”

Miriam Campanella, University of Turin, Senior Fellow, European Centre for International Political Economy, Brussels

Taking stock: clear points for development

As outlined, there is a wide range of challenges facing RMB internationalisation:

- Some reflect the gap between China’s long-term ambition and policy trajectory on the one hand, and the market’s interpretation of short-term tactical measures on the other, e.g. new limits on capital outflows;
- China’s desire for stability is understandable, as is market bearishness for a devalued RMB.
- Institutions and index providers can do more themselves in advance of the next pick up in RMB interest – however, clearer communications from policy makers would likely encourage them to do so earlier and more thoroughly.

“Yes, foreign players don’t invest enough in China because they are aware of the difficulties. They have learnt the lessons from other players failing in China in other industries. They are realistic and are waiting to be convinced.”

TF Cheng, Managing Director at BNP Paribas Asset Management
Sentiment on challenges

Challenges in growing international RMB business
*(Top 5 selected from 2016 survey, ranked by popularity, with corresponding 2015 ranking)*

Regulation has become more important than last year, relative to other factors. Regulatory restrictions remains #1 but is now joined in 2nd place by a lack of regulatory clarity. As suggested by several interviewees, perhaps this reflects that when reforming announcements are made the market would like to see more clarity or details at the time, rather than wait several months until more detailed guidelines are published.

“From our perspective, a potential threat to RMB internationalisation is the onshore-offshore spread – a wide CNY/CNH divergence will make operations of RMB users more challenging. Ongoing reforms that promote greater integration between the onshore and offshore markets should reduce the risk of spikes in the spread over time.”

Julien Martin, Head of FIC Product Development, HKEX

“RMB internationalisation is not China’s #1 priority, stability is.”

TF Cheng, Managing Director at BNP Paribas Asset Management
There are a number of practical areas where further efforts would facilitate RMB internationalisation. Naturally, their prioritisation will depend on the position of the viewer.

Broadly, we see four sets of actors (foreign states, the Chinese state, foreign market players, and China’s market players). Each group has a set of realistic solutions which they can pursue, although there are clearly strong interdependencies. These ‘action lists’ are also clearly generic, and would vary significantly by entity.

Ball in your court: what foreign states can do

There are some fairly obvious geo-political points here for those countries that want to benefit from RMB internationalisation.

- Develop strong bilateral ties with China with a clear long-game in mind, ties that can withstand short-term pressures and changes in government.
- Institutionalise such efforts, both in terms of symbolism, and also for consistency in messaging with China over successive administrations. This might be in the form of a framework, like the UK-China Economic and Financial Dialogue, or dedicated state agencies or members of government.
- Encourage Foreign Direct Investment (FDI) from China, as appropriate.
- If not already a signatory for Belt and Road, seek inclusion as relevant.
- Continually push to develop existing cross-border initiatives, from currency swaps to investment programme quotas.
- Engage your domestic private sector to encourage uptake on terms relevant to them.
- Where relevant, encourage connectivity between capital markets, e.g. the proposed Shanghai-London Connect could strengthen offshore RMB credentials. Neither does it have to be limited to stocks. For example, London is the world’s largest FX spot market and this would be of great value to Chinese banks and trading companies.
- Where relevant, consider RMB as a default reserve and/or settlement currency. This has been pioneered by a number of African countries, including Nigeria, Ghana, South Africa and Zimbabwe, the latter where it forms one of several legal tenders in the absence of a native currency.

Centre stage: the Chinese state

Besides more communication, we observed several consistent themes for Beijing, both from interviewees and our survey respondents.

- Continue working on cross-border initiatives, including supporting existing programmes, as well as new initiatives (e.g. QDLP and QDII2), or review restrictions which make them necessary.
- Seek greater onshore capital market maturity, for equities, bonds, derivatives and currencies.
- Further liberalising China’s capital market as well as the financial services industry will give stronger incentive to foreign players to make the investment in RMB, and bring the resulting knowledge transfer to Chinese counterparties. Without the opportunity to invest in RMB or more streamlined offshore clearing processes, there is suppressed demand to settle trade.
- Consider ways to elevate communications, engaging and enthusing the market, thereby increasing confidence in China’s long-term RMB intentions, and understanding on short-term tactical policies.

“As China is facing a rapidly ageing population, both pension funds and retail investors will need to improve their risk-adjusted return to cater for imminent retirement needs. One solution will be to remove the QDII quota to allow local investors to invest in foreign equities to diversify their portfolio away from home bias and the associated concentration risk.”

Shirley Low Storchenegger, Managing Director, Head of Asia Pacific, STOXX Limited

“Anything that can broaden the capacity of foreign players to invest in China is a good initiative. The real game changer could be a London or Sydney-Shanghai Stock Connect.”

Danny Armstrong, General Manager, International Branches, Corporate & Institutional Banking, National Australia Bank
Just do it? Where the foreign private sector can do more

Opportunities in providing financial services in and with China have been rarely understood, let alone successfully exploited by foreign institutions.

As well as external factors, this surely also reflects internal aspects, from onerous or Western-centric internal risk approval processes, or the physical location of key global personnel and decisions, to the individual long-term priorities of leadership.

Here is a list of potential solutions. Not all will apply to all market players, but as a whole, they demonstrate opportunities for improvement and innovation within existing regulatory frameworks.

![Invest in people and organisational structures:](image1)
- Consider a person or team dedicated to assessing client demand for and knowledge of international RMB products and investment services, and subsequent liaising with clients to keep them abreast;
- Consider a senior person, ideally with experience of interacting with China’s public sector, well able to articulate your case regulatory change, as your contact with Chinese regulatory authorities (and key Chinese market players);
- As necessary, restructure global and regional organisational set-ups to give RMB / China units reporting lines and budget proportional to ambition;
- Consider physical location of key RMB personnel;
- Consider performance targets, measures and incentive systems to motivate and retain RMB personnel.

The proportions of survey respondents currently with such dedicated persons in place is consistently 15% or less. We would expect this to rise in time.

![Making greater use of untapped opportunities:](image2)
- For example, greater use of existing quotas. US university endowments have made greater use of their quotas than UK fund managers, the latter highlighted for caution on China returns by one of our interviewees: “To be an international fund centre, London needs greater China exposure”;
- In such cases, the private sector is expected, from a Chinese perspective at least, to appear more supportive in making the most of wider bilateral opportunities brokered between state actors.

Many foreign private sector players will understandably prefer to wait before making significant investments. The onus for China’s currency naturally rests with China, and yet several of the above steps can be pragmatically mapped out with phased implementation, proportional both to company ambition, and short-term regulatory adjustments.

![Determine the level of China and RMB exposure suitable to your wider strategic and financial ambition, and your company’s core capabilities:](image3)
- Do your homework, build your business case, investment needs, breakeven period, etc. to form a realistic picture of the level of sustained commitment you will need for your RMB plans;
- Ensure that senior and staff buy-in to an RMB initiative is proportionate, and sufficiently informed of the long-term commitment required.

![Invest in RMB and China propositions, with product development teams focusing on RMB products tailored to regulatory challenges. For example:](image4)
- Products for sudden RMB depreciation;
- Commodities and commodity derivatives;
- Compliant means to hedge RMB, e.g. development of NDF market;
- Placing existing RMB products and services more prominently on platforms;
- Analyst (e.g. S&P, Moody’s) offering in China including Shanghai and Shenzhen exchanges with local analysis capabilities to improve onshore transparency;
- Index (e.g. MSCI, FTSE Russell) full proportional inclusion of A-shares (with a clear phasing plan)

![Invest in processes, controls, and infrastructure:](image5)
- Review existing risk approval processes and whether design features for USD and Western-dominated trades or investment are realistic for RMB or the China market;
- Review existing IT systems for interoperability with key RMB infrastructure, e.g. CIPS.
You first: China’s financial services sector

To date, the strategy of China’s domestic players (state-owned, joint-stock or private) has been limited to capitalising on the opportunities specific to each wave of deregulation, leveraging their domestic player and first mover advantages.

Very few have invested in a cross-border RMB business on a global scale, or sought to pioneer beyond traditional service lines into a space where they may have a competitive advantage. There is a wider point here, cited by several of our interviewees, about the domestic financial services sector in China: a need to encourage players to emerge from cautious wait-and-see positions.

Despite this, China’s financial services sector is undergoing dramatic change, and on some fronts has leapfrogged Western equivalents.

New tech disrupters entering the financial services landscape, such as Tencent and Alibaba, have both the momentum and, increasingly, the global talent base. Innovative financial solutions are now more likely to have RMB as a default currency choice beyond China, because of such tech players pioneering both inside and outside China.

From peer-to-peer lending, crowdfunding, or mobile payments (where Chinese consumers display some of the highest rates globally, with over a third of smartphone users paying via WeChat and over 70% using Alipay¹), expect China’s tech sector to play a part in the growth of RMB’s acceptance globally.

Elsewhere, we see Chinese wealth management (asset management companies, IFAs) providing offshore services, but not yet attracting foreign investors into the Chinese market.

Securities companies already provide offshore M&A and financing services to Chinese enterprises. In the future, they may also attract onshore foreign enterprises, and indeed expand internationally.

However, it is China’s ‘Big 5’ banks, given their state-owned and clearing bank status, that are effectively the lead ambassadors for RMB internationalisation.

They therefore have an important role in implementing solutions, with some applicability across the Chinese financial services sector, and certain similarities to both those solutions for foreign private players and the Chinese state.

Taking stock: opportunities to progress

While there is strong interdependency, particularly with Chinese regulation, there are clearly steps that can be taken for organisations to strengthen their RMB approach, regardless of what others do.

- Determine and clearly articulate to foreign markets your offering, differentiated from Chinese peers. This should be reflective of your existing strengths, and where necessary, offshore geographic footprint vis-à-vis others.
- Invest in offshore propositions, with product development teams focusing on localised products (e.g. trade settlement, commodity pricing, infrastructure loans, investment options) and marketing to raise awareness among corporates, institutions and retail investors.
- Invest in processes, controls, and infrastructure, for example existing trade settlement processes, comparing user experience vis-à-vis USD settlement, streamlining and automating processes as applicable.
- Enact cultural change, starting with more internationally experienced management, particularly in key offshore hubs. Use talent available in local markets to tailor superior solutions and customer service.
- Consider senior persons, ideally with experience of interacting with or working in foreign institutions to articulate your proposition and case for local partnerships.
- As necessary, restructure global and regional organisational set-ups to give offshore hubs reporting lines and budget proportional to your overall ambition in internationalising RMB.
- Consider performance targets, measures and incentive systems to motivate and retain an increased proportion of international personnel.

“*If Chinese securities firms become more visible in international markets, they can support the next phase of RMB internationalisation: the RMB as a capital markets currency.*”

Martina Garcia, Head of Emerging Markets Strategy, London Stock Exchange Group

Source: 1) China’s Connected Consumers, 2016, KPMG
### Policy steps needed to accelerate global adoption of RMB as an investment currency
*(Top 5 selected from 2016 survey, %)*

2015’s results were influenced by that year’s government intervention in onshore equity markets. With intervention in equity cooling, by focusing just on 2016’s results, we see clear messaging on other aspects of the state’s role...

<table>
<thead>
<tr>
<th>Policy Step</th>
<th>%</th>
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<tbody>
<tr>
<td>A free-floating exchange rate</td>
<td>19%</td>
</tr>
<tr>
<td>Removal of quotas for cross-border investment schemes</td>
<td>14%</td>
</tr>
<tr>
<td>Lifting of restrictions on foreign investment in China’s financial services sector</td>
<td>13%</td>
</tr>
<tr>
<td>Less government intervention in onshore equity markets</td>
<td>10%</td>
</tr>
<tr>
<td>Accelerated pace of interest rate liberalisation</td>
<td>10%</td>
</tr>
</tbody>
</table>

### Market developments needed to accelerate global adoption of RMB as an investment currency
*(Top 5 selected from 2016 survey, %)*

...although there are several clear messages for the private sector too.

<table>
<thead>
<tr>
<th>Development</th>
<th>%</th>
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<tbody>
<tr>
<td>Improved clarity of legal infrastructure related to mainland securities</td>
<td>16%</td>
</tr>
<tr>
<td>Inclusion of China A Shares in emerging market indices (e.g. MSCI)</td>
<td>12%</td>
</tr>
<tr>
<td>More offshore RMB clearing centres</td>
<td>12%</td>
</tr>
<tr>
<td>Greater international pricing of commodities in RMB</td>
<td>12%</td>
</tr>
<tr>
<td>Improvement of company transparency in onshore financial markets</td>
<td>11%</td>
</tr>
</tbody>
</table>

### Respondents’ businesses have...
*(Top 5 selected from 2016 survey, %)*

<table>
<thead>
<tr>
<th>Business Need</th>
<th>%</th>
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<tbody>
<tr>
<td>A team dedicated to assessing client demand for and knowledge of international RMB products and investment services</td>
<td>15%</td>
</tr>
<tr>
<td>A compliance officer or banker in contact with Chinese regulatory authorities to keep abreast of current regulatory developments</td>
<td>14%</td>
</tr>
<tr>
<td>Product development teams that focus on RMB products tailored to regulatory changes</td>
<td>13%</td>
</tr>
<tr>
<td>A specialist or specialists to liaise with clients to inform them on cross-border/international RMB developments</td>
<td>11%</td>
</tr>
<tr>
<td>Officials/ a team that meets with regulators to explain/ educate regarding risk management tools that can be adopted for RMB, and to encourage further easing of regulations</td>
<td>11%</td>
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</table>

### What financial services companies need to do most urgently to increase their international RMB business
*(Top 5 selected from 2016 survey, %)*

<table>
<thead>
<tr>
<th>Urgent Action</th>
<th>%</th>
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</thead>
<tbody>
<tr>
<td>Create more channels for RMB liquidity/ access to liquidity for international clients</td>
<td>15%</td>
</tr>
<tr>
<td>Invest more in staff training on international RMB products/ services and markets</td>
<td>13%</td>
</tr>
<tr>
<td>Improve their connections/relationships with mainland regulators/ authorities</td>
<td>13%</td>
</tr>
<tr>
<td>Reallocate resources towards international RMB services</td>
<td>13%</td>
</tr>
<tr>
<td>Improve their connections/relationships with major Chinese banks</td>
<td>11%</td>
</tr>
</tbody>
</table>
The balance of opportunities, challenges, and possible solutions that we have covered points to a number of likely developments.

**The crystal ball: what to look out for in the next 12 months**

The launch of Shenzhen-Hong Kong Connect can boost the CNH market in Hong Kong and further open China’s stock market, particularly its tech sector, to the global community.

Given RMB depreciation, Shenzhen’s December 2016 launch cannot be compared with the 2014 opening of Shanghai Connect (when daily quotas were hit on the first day of trading). In the first week trading of Shenzhen stocks reached CNY12.3bn, while trading of Hong Kong stocks reached CNY3.1bn. This northbound emphasis is understandable, given mainland investors could already use the Shanghai Connect to access Hong Kong. However, this Shenzhen trade volume represents under 20% of northbound quota use.

We would expect northbound investment levels to remain below their potential as long as speculation around further FX depreciation persists. If the market in 2017 perceives depreciation to have halted or reversed, the daily quotas of both Shanghai and Shenzhen initiatives might once more become relevant.

From our interviews, we see anticipation in the market that several cross-border programmes currently on the periphery will see some sort of regulatory and usage volume breakthroughs. They await the announcement of further northbound MRF participants, and further clarity around the rules allowing participation in QDLP and QDII2. They foresee a bond connect between Shanghai and Hong Kong (despite the relatively modest size of the bond market in either).

There is also an expectation that an insurance programme, similar to MRF, will address mainland undersupply. Further liberalisation of the FTZs, especially in Shanghai, is expected to encourage better use of RMB in trade settlement, but also to enable qualified individuals and perhaps institutions to directly deploy their capital offshore.

All of the above, however, relies on a relative absence of market shocks. It is also subservient to Chinese regulators’ more pressing needs to stabilise the exchange rate and stem the related capital flight.

A majority of our survey respondents felt it too soon to call the impact of Brexit on London’s RMB future. Sentiment was more positive outside of Europe and the UK, with 19% of our mainland China and Hong Kong survey respondents predicting an enhancement to London’s role as a result of Brexit.

In terms of offshore hubs, expect London to build on its position, second only to Hong Kong, as a RMB clearing centre. RMB now accounts for roughly 40% of all payments in the mainland China + Hong Kong-UK corridor, ahead of both HKD and GBP – with the RMB likely to rise further than its current 8th position among the city’s most-traded currencies.

“There are many external factors to impact RMB’s march, from stalled Brexit negotiations to another EU member exit referendum to US-China relations. But within China, credit defaults, especially bond failures at the local government level, could really derail things.”

Stewart Aldcroft, Senior Advisor, Citi, Chairman of Cititrust Limited

While it is unlikely that all of those predictions receive a green light over the next 12 months, there are Chinese state resources labouring on several of them as you read – and they will expect participants from the private sector and other governments to match any commitments that do materialise by making a material investment of time and resources.
The long game: the next 3-5 years and beyond

Further ahead, our interviewees generally expect the fundamentals to take over from regulation-driven initiatives in the RMB journey.

Most of the reasons why the global community choose to hold RMB in the first place should persist: a robust economy, a capital market that helps diversify and generate attractive risk-adjusted returns, the facility to trade, settle in and hold the currency, growing trade with the rest of the world – the list goes on. This longer-term journey will likely be remarked by particular events, including removal of quotas, and full convertibility of the RMB currency, which our survey respondents largely see as around 5-10 years away.

A higher RMB allocation within the SDR portfolio is likely, and expect London to have the first of several Western stock connects with Shanghai. Yet, be realistic about how and where RMB offshore hubs will grow – capital markets, for example, need economies of scale and in this regard Hong Kong will remain the primary offshore centre for RMB.

The implication is that many banks, asset managers and insurers are unprepared for this index reweighting. In other words, there is an overdue need to reassess strategies, increase investment into RMB-related infrastructure, product portfolio, relationships and talent. In time, most major global financial service players will need an RMB version of their main products.

However, only banks have done meaningful work to date. Other types of financial service companies, even if their strategy is not to focus on the China market, will see growing demand from their customers for RMB-related products and services.

On aspirations for the RMB to become a global reserve currency, however, there is still some way to go. Consider that all forms of offshore RMB total CNY1-2 trillion (~USD140-290 billion). Yet offshore USD reserves held by foreign governments (let alone individuals) is around USD4.8 trillion. There could therefore be in the magnitude of 20-50 times the value of offshore USD in circulation, compared with RMB.

Regulation aside, this relative delta in size of offshore currency pools makes the RMB illiquid in comparison, and therefore amounts to a major barrier in switching to RMB. Anything that bridges this delta, should therefore help.

In the bonds space, for example, MOF issuance of RMB-denominated bonds in offshore centres helps build a more liquid market for CNH China sovereign debts, which form the underlying assets of interest rate derivatives. CNH interest rate futures and swap markets can help build a more complete market-driven yield curve for CNH, and therefore help the RMB become a medium to store value.

Given the sheer scale of what could happen over the next five or so years, it is perhaps not surprising that so few stakeholders have given much thought to the magnitude of both opportunities and challenges. As a plurality of our survey respondents felt across a number of product and asset areas, RMB business has limited opportunities for growth without further regulatory liberalisation.

Source: 1) Citi, November 2016

Source: 2) HKMA, Central Bank of Taiwan, MAS, Bourse Consult; 2) IMF, 2016
Do your homework: identifying and planning for practical implications

From our own experience in working with new market entrants and those who have a longer presence in China’s financial service space, we see a number of recurring themes in terms of unanticipated implications, or underestimated challenges.

Quite often this comes down to practicalities like finding sufficiently strong front line staff, and how best to incentivise them, not to mention meaningfully integrating the potential of big data.

We use a checklist of sorts, what we term the ‘9 Levers of Value’ framework, to map out a blueprint for new market and product launch strategies, or to anticipate the interdependencies of a particular strategic choice. See these as complementary to those ‘action lists’ we outlined on pages 20-22.

Taking stock: next steps for those players investing in RMB propositions

Whatever level of RMB product and service exposure you seek to grow, consider the implications of your options along each of these levers.

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Note: Learn more about the 9 Levers of Value at kpmg.com/strategy
Brexit sentiment

The potential for London’s role in RMB post-Brexit?
(2016 survey results, % respondents by geography)

The UK’s referendum, resulting in a vote to leave the European Union, may have contributed to a further devaluation of the RMB. In short, investors dislike the uncertainty that the vote brings, and that leads to a wider withdrawal back to the ‘safe’ default of USD. The presidential election in the US has had a similar effect, but given London’s more developed aspirations to be an RMB offshore hub than those of New York, we sought to explore Brexit implications a little further.

There is no shortage of speculation around the negatives or positives of Brexit for London as a financial centre. Yet to state the obvious, it is too soon to tell. The details of the UK’s renegotiated future relationship with the European Union, and therefore other third countries, like China, may become more clear in 2017-18. Prophecies can, however, become self-fulfilling, as the GBP’s tumble demonstrates – the market second-guessing itself on relatively few data points of what Brexit actually entails.

For this reason, we sought to compare respondent sentiment by region, revealing that markets outside of Europe were more upbeat on London’s chances. This is backed by our mainland China and Hong Kong sector interviewees, who exclusively talked in either neutral or positive terms about Brexit’s impact on London’s role as an RMB hub. Others pointed out that the implications were not restricted to the UK.

“The UK is culturally used to an international trading environment and reacts quickly. Europe and the US need more time.”
Eleanor Wan, Chief Executive Officer of BEA Union Investment Management

“Perhaps Brexit is the long overdue push Europe needed to change its investment regulations.”
Miriam Campanella, University of Turin; Senior Fellow, European Centre for International Political Economy, Brussels

“Hong Kong is proactive in promoting its relevance to RMB internationalisation and keeping its position as a financial centre. The other obvious example is London with the support of the City of London and the UK authorities. Elsewhere there is less of a sustained drive to be an RMB hub.”
Justin Zhang, General Manager, Research Department, CFETS

“Brexit will not impact London’s offshore potential, despite noise to the contrary.”
Stewart Aldcroft, Senior Advisor, Citi, Chairman of Cititrust Limited
Conclusions

1. **We are at a tipping point for RMB trajectory. Do not expect a return to pre-2015 levels of optimism, but internationalisation will continue.**

   It is a truism to paint the present as uncertain. But in a sense, for RMB internationalisation the period since mid-2015 and continuing into 2017 is a pivotal period. For the best part of a decade up to 2015 there was a reasonably steady, if not particularly fast, march of RMB liberalisation and internationalisation, or at least the RMB’s steady appreciation against the USD meant RMB propositions did not need to be particularly sophisticated to gain interest.

   From our research for this report, and our wider interactions in China, we believe China’s long-term ambitions for the RMB remain unchanged. The authorities will continue to liberalise China’s wider financial service sector at a pace of their own choosing, and always with an eye for stability over market enthusiasm.

   The dampening of demand for RMB products and market sentiment that is apparent throughout this report’s analysis is temporary. However, we are also unlikely to see a repeat of pre-2015 levels of optimism around RMB internationalisation.

   As our survey responses suggest, the view in 2016 was, if anything, more restrained than in 2015 – with a shift from predicted full convertibility from 5 to 7+ years, and similar lengthening of predictions around the time to become a major global investment currency or the world’s most commonly used currency.

   "This is the key challenge: While the regulators address concerns of preventing capital outflows on the one hand, there should at least be as strong a need to improve foreign investor confidence on policies that impact convertibility and liquidity of the RMB on the other.”

   Vivien Teu, Managing Partner of financial services law firm, Vivien Teu & Co (affiliated with Llinks Law Offices)

   "Given the current stresses in the economy and the financial services sector in particular, the current level of capital flows is actually a strength of the system. Further aggressive internationalisation of the RMB may not actually be advisable in the current environment and not until the economy and credit cycle is on more stable footing.”

   Jason Bedford, Director, Asian Financials Research, UBS IB

2. **What happens next? Further growth of the RMB abroad requires both trade and investment reforms.**

   The trade side of RMB is already relatively liberalised. Yet as we have outlined, RMB adoption in trade is low in relation to China’s share of global trade. Documentation levels (e.g. those linked to PBoC scrutiny of trades to eliminate arbitrage) and a restricted club of clearing banks sets the RMB at a clear disadvantage.

   Along with our point around mindset, existing trading relationships also have their incumbent currencies.

   Once a foreign party does agree to be paid in RMB, the challenge emerges of where they can readily invest it – China has a rapidly-growing capital market which, from a risk-return perspective, looks quite attractive, yet much of it is currently restricted to domestic investor access.
We have touched on such specifics as equity share restrictions, and whether the RMB can be a medium to store value without market-driven interest rates. Most of our interviewees remain cautious on whether sufficient infrastructure is yet in place or whether cultural gaps can be readily bridged.

It is therefore clear that the state’s centrality in RMB internationalisation brings its fair share of expectations from the market. To be effective, however, further steps from the authorities will have to be supplemented with the necessary investment in its state-owned ‘big 5’ banks – the effective champions of RMB uptake in markets globally.

3 The resulting question for many market players: invest ahead of the curve or wait-and-see?

Those countries, banks and other institutions that invest now have the potential to benefit from what is still a relatively early mover advantage. It is only a matter of time before exchange rates encourage a rebound in demand for RMB products and services. Those market players investing in a clear strategy today will be better positioned to benefit from that upturn.

On the other hand, significant investment in RMB and China in general will not be the right strategic answer for many players globally. Countries and institutions should have a clear view of their own core competencies and long-term commitment levels that a serious ‘China play’ requires. China’s regulations or immediate returns do not entice foreign players. Rather, it is the scale of the long-term opportunity that attracts interest. Given obvious uncertainties, few put exact figures on this scale. Indicatively, however, if US benchmarks were reached with China’s current economic trajectory, there could be fourfold growth in both bond and stock markets by 2025.¹

A third answer, which we saw evidence of during our interviews, is wait-and-see. As our survey also suggests, regulatory ambiguity is an issue for the market. Some players will therefore argue that there is simply not enough information currently available on which to invest time and resources in an RMB business. Holders of such a view are realistic enough to know that this may set them at a disadvantage later, but it also understandably highlights regulatory clarity and communication. Several interviewees were mindful of what the wider market might be thinking: how are they to know that sudden regulatory change will not render their current efforts obsolete?

While many private sector players can and will profit from RMB internationalisation, the status quo of USD dominance is also acceptable to many. The onus for keeping China’s currency ambitions on track ultimately resides with those that hold the ambition in the first place.

We have highlighted the importance of clear regulation, as well as the need to balance this with China’s preference for stability. China’s policy makers will remain at the heart of RMB internationalisation, but interstate and public-private developments are key contributors. This is an ongoing story about expanding collaboration, geographically and institutionally. It is a story shifting from being primarily about the pace of liberalisation to one about how multiple players interact to mutually benefit.

The fun bit: further context and methodology

KPMG has been sponsored by the UK Department for International Trade, with the China Foreign Exchange Trade System, to commission an updated view on the internationalisation of the RMB. This follows a 2015 publication of the same theme authored by the Economist Intelligence Unit (EIU).

During October-November 2016 KPMG interviewed 15 senior personnel from financial service companies as the basis of fieldwork. Those interviewees are listed to the right.

In addition, for continuity with the 2015 report, KPMG surveyed a further 200 market participants to seek wider sentiment change on a number of questions originally asked in the previous report. Within that, there were over 50 full completions (i.e. participants able to answer all questions) including representatives from HSBC and China’s Big 5 banks. The interviewee and survey sample includes mainland China, Hong Kong, UK, Singapore, Australia, India, continental Europe and North America-based persons, across banks, securities firms, asset managers, asset owners, multinational corporates, as well as industry commentators.

The above primary research was supplemented with secondary research based on public and proprietary information, some of it provided to KPMG by those interviewed and surveyed.

Howhow Zhang was the author of this report, and Chris Brown its editor. Thomas Chan and Simon Gleave provided oversight, while Lillian Zhu, Seraphine Ellis and James Harte provided support.

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We would like to thank all interviewees and survey respondents for their contribution.

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