Australian Chamber of Commerce
Beijing and Shanghai
Financial Services Working Group

Australian Financial Services Business in China

2012 White Paper

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About AustCham

The China-Australia Chamber of Commerce (AustCham) is focussed on strengthening Australia-China business, government and community relationships and AustCham member interests in China, by being an effective source of information, connections and representation.

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The information contained in this White Paper is based on input and analysis in the 12 months to April 2012.

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Welcome Message

Welcome to the 2012 White Paper on Australian financial services business in China, the second annual report prepared by the Australian Chambers of Commerce (AustCham) in Beijing and Shanghai.

China in 2012 is transitioning to a new generation of political leaders, that is seeking to make its economy more sustainable domestically, and more competitive globally. The changes to China's economic growth model and its competitive standing in the world will have profound implications for Australia, the region and globally.

Given the unique and critical role that an effective and efficient financial system plays in an economy, the reform of China's financial sector will be a prerequisite to China achieving its economic goals and to successfully integrating within the global economy.

The restructuring and opening up of China's financial markets has been at the heart of China's reform agenda for more than two decades. On any measure, the progress made over that time has been remarkable and China is to be applauded for its efforts.

Investment and participation in the Chinese markets by Australian financial institutions has been growing and it is clear from AustCham member feedback that these institutions remain eager to continue investing in a well-regulated, transparent, open and efficient financial services sector.

In this report, we comment, from an Australian business perspective, on important developments that have occurred over the last 12 months. In the spirit of cooperation and true partnership, we put forward a number of recommendations which, if implemented, we believe will encourage not only the continued investment by Australian financial institutions into China, but which may also play an important role in the ongoing development of China's financial markets.

We also outline recent developments in the Australian financial markets, which may be of interest given that Chinese participation in the Australian financial markets is growing steadily. This paper highlights the opportunities that Australia's knowledge and expertise presents to globalising Chinese financial institutions.

The paper has been prepared with the intention of forming the basis of discussions with China's policy makers and regulators, and over coming months we look forward to continuing an active dialogue on these topics.

In addition to the policy recommendations we have outlined a number of practical topics directly relevant to the operating environment for Australian financial institutions. We hope that they may illustrate some of the challenges faced by Australian institutions in this market and provide guidance as to possible measures that can be adopted.

We would like to express our thanks to members of the Financial Services Working Groups of AustCham in Beijing and Shanghai for the time that they have committed to the development of this paper. That time and effort is a reflection of the significant importance of the China market to our members.

This year marks the 40th Anniversary of full diplomatic relations between China and Australia. We are confident that the dialogue that has already commenced around these topics will continue; and that each nation may be able to leverage our respective strengths to promote and encourage the ongoing development of resilient and integrated regional financial markets.

David Olsson
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Financial Services Working Group
AustCham Beijing

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Progress and change – reviewing the past 12 months

Bilateral relationship strengthening

At a bilateral level, over the past 12 months the Chinese and Australian governments have reaffirmed their mutual commitment to the removal or reduction of tariffs and non-tariff barriers, the reduction or removal of regulatory barriers and the implementation of measures to encourage more foreign investment between Australia and China, including in the financial services sector.

The dialogue at Ministerial level, between regulators and with business, has been regular, is more coordinated, more focused and is involving a wider range of participants. These are very welcome developments, which point to a deeper level of cooperation and engagement.

China's reform program continues

China has continued to push ahead with important reforms and policies aimed at increasing efficiency, promoting a more balanced system between state-owned enterprise and private enterprise, creating more transparency and bringing about more accountability.

Australian financial institutions operating in China are encouraged by positive changes in the Chinese sector, such as:

- the increased communication with Chinese regulators and policy makers, and the increasingly efficient and coordinated approach to reform in the sector;
- the focus and continuing policies of RMB internationalisation and the recent widening of the tradable RMB exchange rate band;
- the recent signing in March 2012 of a bilateral local currency swap agreement between the Reserve Bank of Australia (RBA) and the People's Bank of China (PBOC) for the exchange of AUD30 billion or RMB200 billion, which highlights the growing financial integration between Australia and China;
- the increasing interest of Chinese financial institutions to leverage the expertise of Australian financial institutions; and
- the commitment to improving financial systems in domestic regions such as permitting qualified foreign partners, e.g. overseas hedge funds and venture capital funds to raise RMB funds in China for offshore investment, developing a cross-border RMB lending scheme for Hong Kong – Shenzhen to enable direct client lending, and reforming the informal lending and private lending systems in Wenzhou.

Chinese participation in the Australian market grows

Chinese banks and financial institutions have also been actively developing their businesses in Australia. In our 2011 White Paper we commented that many have a formal presence in Australia or are conducting business on a regular basis.

That trend has continued over the last year, with many Chinese commercial banks becoming active participants in the Australian loan markets, especially to Chinese entities involved in the energy and resources sectors. These loans have been made directly by Chinese banks or in syndicates involving Australian commercial banks.

More recently we note that the services being provided, extend beyond loans to trade finance and transactional services (including RMB trade settlements) and securities and investment banking services. The customer base is also extending beyond parties in non-mining sectors (e.g. agri-business) and to both residential and corporate clients.

This depth of engagement in the Australian markets is set to continue, reflecting the growing importance of the Australian market to Chinese institutions. Australia has become an important testing ground for investments, helping Chinese banks to acquire experience, skills and capabilities. Partnerships with Chinese banks have the potential to provide further banking services in Australia and to unlock opportunities within China itself.

Australia's financial markets are growing and providing opportunities

Like China, the Australian economy continues to perform solidly, notwithstanding continuing global market volatility. The International Monetary Fund (IMF) recently stated that the Australian economy is expected to outstrip growth of most other advanced economies over the next two years, and is less likely to be directly impacted by European banking system issues than other countries.[1]

Australia's financial sector continues to rank highly at number five globally.[2] Australia's funds management sector continues to perform strongly and has grown seven-fold since 1991, and now has AUD1.8 trillion in funds under management. Australia's financial markets are recognised as sophisticated, deep and highly liquid. Aside from Japan, its stock market is the largest in the region and the sixth largest globally.[3]

Australia's financial services sector is one of the most efficient and sophisticated in the world. With a highly educated and expert financial services talent pool, Australia offers China an ideal regional partnership opportunity to build domestic capability through access to this talent.

Australia's mature financial services sector also provides China with a solid reference for best practice in technology, process and regulation, and insights on how to improve systems of corporate governance, risk management, internal control – all of which are essential building blocks for a strong, integrated regional financial system.

Against this solid Australian domestic backdrop, Australian financial institutions continue to seek opportunities to partner with China, and support the Chinese financial services sector in its development.

1. *International Monetary Fund World Economic Outlook 2012 – released 17 April 2012*
2. *World Economic Forum: The Financial Development Report 2011.*
3. *Austrade 2011 Benchmark Report: Australia – a wealth of opportunities*

Update on the Australian Financial Services sector

Australia's financial services sector has an excellent reputation for stability, product innovation, advanced capital and risk management systems, robust and transparent regulatory framework and highly skilled workforce.

In the past 12 months, the Australian Government and key financial services regulatory authorities have undertaken reforms to maintain a transparent and stable financial system. The Australian Prudential Regulation Association (APRA) recently announced further significant reforms on capital products and liquidity. The Australian Government also recently revised the Banking Act to allow Australian banks and other authorised deposit-taking institutions (ADIs) to issue covered bonds. This has been a welcome development and there have already been two successful issues.

Following are some of the areas of particular focus for the Australian sector, in terms of reform and development.

Consumer protection

In December 2010, the Australian Government announced a program of banking reform to enhance the financial well-being of customers, by improving financial literacy and fostering more competitive, transparent and safe financial markets. During 2011, these reforms have resulted in a simpler, more effective approach to home mortgages. In July 2012, the Australian Government will introduce credit card reforms aimed at introducing more control and transparency for customers.

The Future of Financial Advice (FoFA) legislation is proposed to become law on 1 July 2012. The reforms will introduce a number of limitations relating to conflicted remuneration and other payments to Australian financial services licencees (e.g. banks, insurance companies, trustee companies, securities firms), a statutory 'best interests' obligation and an opt-in regime for ongoing advice fees for Australian financial services licensees that provide personal financial advice.

Superannuation (pensions)

Australia is recognised as operating a 'world's best' superannuation (or pensions) regime.[4] The Australian superannuation system is underpinned by a compulsory contribution for wage earners, which is planned to rise to 12 per cent of salary by 2019-2020.

Reforms instituted by APRA and Australian Securities and Investments Commission (ASIC) have increased prudential standards, increased trustee and director obligations and imposed more stringent risk management processes. At the same time, for superannuation users, APRA has introduced a low-cost superannuation alternative, enabled account consolidation to streamline rollovers and reduce duplication.

Basel III adoption

As a member of the Basel Committee, APRA has been involved in the introduction of Basel III,[5] and is developing a package of aligned reforms to strengthen the capital framework of ADIs in Australia, to take effect from 2013.

Market integrity and market supervision

The Australian Government is increasing competition to exchange markets in Australia by transferring market supervision for local exchanges to Australia's corporate, markets and financial services regulator, ASIC, and setting new market integrity rules to provide the framework for the introduction of competition in equity exchange markets.

Over the past 12 months ASIC has introduced new market integrity rules covering the conduct of operators and participants as well as guidelines for prospectus disclosure. It assumed day-to-day supervision of trading on the ASX (and other domestic financial markets). It also supervised the entry of Chi-X as a licensed operator on the securities exchange and, with it, the introduction of competition between Australian financial market operators.

4. *Melbourne Mercer Global Pension Index 2011*
5. *Basel III: A global regulatory framework for more resilient banks and banking systems, developed by the Basel Committee on Banking Supervision*

Recommendations

High level recommendations

Australian financial institutions are interested and focussed on engaging with Chinese policy makers to encourage domestic reforms, which create a strong foundation upon which the industry can grow and mature.

Based on their experience, the Australian banks, funds and asset management companies, trust companies, securities companies, private equity firms, insurance companies and advisors have documented their observations on specific areas where change could benefit the ongoing development of the entire Chinese financial services sector.

These observations can be summarised under three themes:

1. Increased market access
2. Consistency and equality of market access for all financial institutions that participate in the Chinese financial services sector
3. Deeper and more regular dialogue between China's policy makers, financial regulators and foreign financial institutions.

These three themes are consistent with the recommendations highlighted in the 2011 White Paper, and reinforce the commitment of Australian financial institutions to work closely with the Chinese financial services sector to drive growth of the sector, develop capacity and integrate markets.

Sector specific recommendations
Banking

We are pleased to note that several of the topics raised in the 2011 White Paper have been the subject of new policies or change. In particular:

> the level of communication and engagement with the financial regulators and policy makers has improved significantly over the past 12 months,

> the level of coordination between regulators is becoming more effective, however considerable focus still needs to be applied to improving the coordination between regulatory bodies; and

> the ongoing and dynamic progress being achieved on the internationalisation of the RMB.

This reflects a genuine focus on improving the Chinese financial system by all parties. With this as a foundation, the banks (domestic and foreign) can continue to work closely with the regulators to improve the efficiency and rigour of the developing financial system.

Observation 1: Complexity of application process for licences

Foreign banks are currently faced with challenges relating to the licence application process in China, in particular, the protocol of "one licence at a time" and the 6 to 12 months observation period following the granting of a licence.

In addition some of the licensing processes are not comprehensive. For example, in order to commence their derivative trading business, foreign banks must first apply for derivative licenses from China Banking Regulatory Commission (CBRC) and subsequently obtain separate approvals from the State Administration of Foreign Exchange (SAFE) in order to deal with RMB-related derivative by-products, such as CNY/FX Forward, CNY/FX swap.

Recommendation:
The 'one licence at a time' and 'observation period' restrictions on foreign banks could be removed by requiring the foreign bank to provide appropriate detailed justification for their application, which would assist CBRC in managing multiple licence applications and help the foreign banks to plan their business operations more efficiently. A more streamlined application process for licences could include all basic operating requirements for that licence. For example, the derivatives licence would include basic derivatives products licence requirements as well, such as, FX forward, Cross Currency swap and interest rate swap.

Benefit:
Streamlining the licence application process would result in an increased willingness of foreign banks to invest in China, and increased opportunity for Chinese banks and regulators to access first-hand international financial markets knowledge. Chinese banks would accelerate their understanding of international standards on derivative products which might positively impact their international expansion goals. Chinese financial institutions would benefit from greater customer satisfaction as well as being able to provide greater flexibility for customers when choosing financial products and services.

Observation 2: Implementation timelines for new regulation

Implementation timelines for new regulations are often very short and can prove to be a major challenge to ensure adequate compliance, particularly when technology changes, system changes and new regulatory reporting measures are required. Providing longer lead-in times to implement changes would ensure that banks are able to comply more readily and with greater certainty.

Recommendation:

Establish regular communication and engagement between the Chinese Government and domestic and foreign funded banks, with the aim of working through the operational impacts of proposed and draft regulations so that the timelines for implementation can include the practical business requirements.

Benefit:

Better lead-in times for implementation would result in stable and controlled market operations through reduced operational disruption. Carefully planned implementation of regulatory changes also contributes to lower operating risk.

Observation 3: Application for foreign debt quotas

Concerns have been raised previously about the fact that the methodology around the allocation of foreign debt quotas is not clear. The onerous requirements of providing customer contracts as part of the application for approval of a quota can be inefficient, time consuming and potentially misleading to customers. For example, a bank would need to offer credit facilities to customers in advance of the quota approval, not being certain of the approval being secured. This could cause negative brand implications for the bank and a lack of trust in the banking sector.

Recommendation:

The application for quota approval could include indicative quota requirements based on expected customer contracts, rather than actual. Utilising an acceptable measure or formula would enable the regulator to provide approval, based on carefully calculated estimates.

Benefit:

The customer approval process would not be impacted by regulatory uncertainty, making the process more transparent and efficient. The regulators can be assured of advance estimation of quota requirements from foreign banks, increasing reporting rigour and forecasting.

Observation 4: Uniformity of tax code

There is complexity and lack of uniformity of the taxation code across various regions and cities in China, which impacts the operational effectiveness of the banks, and their ability to deliver a consistent service to customers across different regions in China.

Recommendation:

Bearing in mind the history of disparate tax regimes across regions in China, Chinese tax authorities could take a phased approach to introducing uniformity. The Government could work with local and foreign financial institutions to identify the key areas of the tax codes were consistency would deliver strong benefit with minimal disruption and implementation risk.

Benefit:

Increasing the uniformity of the tax regimes across regions in China will encourage greater investment by foreign funded banks into diverse areas, as well as increasing the operational cost effectiveness of the Chinese banking sector, thereby encouraging additional foreign participants to enter the Chinese financial services market.

Observation 5: Industry specialised talent pool is yet to mature and expand

Currently the trained talent pool is limited, particularly when factoring in foreign language skills and depth of experience. For some specialist roles, it is increasingly difficult to recruit and retain staff.

Recommendation:

Beyond increasing the attractiveness of China (and in particular, leading financial Chinese cities) as a career destination for international talent, consideration could be given to providing tax incentives comparable to Hong Kong or Singapore for employees, as well as employers to invest in experienced foreign trainers who can educate local talent.

Policy makers could establish a 'financial services academy' as a joint venture between Chinese universities and Australian financial institutions, which would result a specialist talent pool that is trained on current international industry practices.

A longer-term talent management plan needs to include a specific education push to enhance professional skills within the financial services sector.

Benefit:

Through investment in training the next generation of domestic professionals, the China financial services sector will be able to establish a self-sufficient talent pool, which will ensure the growth and competiveness of its financial services sector.

Observation 6: China National Advance Payments System (CNAPS) system limitations

Currently, most foreign banks, or those who have recently entered the China financial markets, are unable to access the RMB settlements system (CNAPS) directly, and must do so via a local bank, which causes settlement delay and price impacts. The current CNAPS framework has not been adequately developed to meet the increased numbers of banks requiring access. It is expected that the timeframe for a solution is approximately 2013 - 2014. As the China financial market develops and new RMB products are introduced, foreign banks and their customers will be at an increasing disadvantage due to this access limitation.

Recommendation:

Commence discussions with a small working group of foreign banks to explore the possibility of pragmatic system and process solutions to reduce the time delay. Additionally, communicate with the foreign banks in a timely manner to keep them informed of planned system changes, so that the banks can prepare their proprietary systems for CNAPS access, thereby limiting implementation delay.

With regards to direct consumer payments, Australian banks could share their experience and learnings about the point-of-sale (POS) solutions offered in Australia. These solutions are an outcome of the convergence of telecommunications and financial services industries. They provide advantages to consumers while keeping the cost of investment low by leveraging existing telecommunications infrastructure.

Benefit:

Providing direct access to CNAPS will benefit the Chinese customer in obtaining the best settlement price at the right time, without market disadvantage. This will also drive further efficiency and contribute to a more balanced, equitable financial system.

Previous recommendations, which continue to be of importance:

> Investments - Lift the investment ceiling on foreign banks to three (currently two), particularly in regions of priority development such as Central and Western China.

> Allowable equity interest - Increase the cap on equity investment from 20 per cent to a more reasonable level (e.g. 49 per cent) to increase investment and benefit for less developed regions of China.

> RMB licences - Amend the time limit on obtaining RMB licences, so that those foreign banks that meet the regulatory criteria and perform above industry average have priority.

> Prudential ratios – move towards international consistency of liquidity ratio requirements. Also consider obtaining committed lines of credit from parent entity to meet regulatory prudential ratio requirements.

> Foreign debt ratios - Introduce a more consistent and transparent methodology for the allocation of foreign debt ratios

> Account opening procedures - Adopt a principle or outcome based approach to account opening procedures, instead of a rule or form based approach.

Other banking recommendations:

> For foreign funded branches where a banking licence is held, allow an expansion of Representative Office activities to include basic banking services to customers such as account opening and accepting instructions.

> Allow statutory deposits to be included in bank branch liquidity calculations, that is, allow statutory deposits to be treated as current asset regardless of term of deposit.

> Put in place clear guidelines for allowing capital injections including limits and process, which would be this is applicable to any foreign entity such as a bank or wholly owned foreign enterprise (WOFE).

> Allow all banks to access the PBOC Credit System to ensure all available information is used in making credit risk decisions.

> Review the volume and frequency of regulatory reporting, especially the need to submit reports for products/services not included in the bank's Banking Licence.

> Liberalise the Capital Account in order to allow all banks the access to a greater source of funding options. This is the key restraint imposed on foreign funded banks who cannot effectively fund themselves onshore, and are limited in their ability to receive funding from the parent entity or other offshore sources.

> Liberalise the domestic interest rate regime with regards to regulated currencies and the RMB. With their ability to attract large deposit bases, domestic banks are able to apply a fixed margin on deposits and loans, thus contributing to disproportionate profitability.

Sector specific recommendations
Funds & asset management

Opening up the funds management sector to an equal level participation by Chinese state-owned institutions and other Qualified Foreign Institutional Investors (QFIIs) and Qualified Domestic Institutional Investors (QDIIs) will result in a more competitive, liquid and high growth sector, with the added benefit of flow-on impact to the overall Chinese financial sector.

Observation 7: Capital Gains tax amendments

The State Administration of Taxation's (SAT) Circular 698 entitled "Circular on Strengthening the Administration on Collection of Enterprise Income from Enterprise Transfer by Non-resident Enterprises" imposes an obligation to report and pay tax on direct transfers of PRC enterprises, as well as, in certain circumstances, an obligation to report indirect transfers of PRC enterprises. The Circular has made offshore indirect disposal an uncertain mechanism of investment exit from a tax perspective. This has focused attention on offshore direct exits and onshore exits, and impacts cross-border M&A in China, causing challenges for strategic investments of multinational companies as well as for private equity funds investments. The uncertainty around application of the Circular further adds to the potential negative impact.

Recommendation:

The SAT needs to clarify the application of the new tax provision. In particular, clarity around where the tax obligation rests is critical, to provide clarity for all stakeholders in an investment transaction.

Benefit:

The alignment of onshore and offshore taxation regimes would simplify the foreign investors' decisions made across multiple tax regimes and would help investors understand how best to factor in the potential tax obligation into their cross-border investment forecasting.

Observation 8: Repatriation of capital to China

The ability for on-shoring and repatriation of capital to China continues to be restrictive. The Ministry of Commerce (MOFCOM) rules are narrow in definition, such that unless 'returning RMB' meet a specific definition of 'source', they are excluded. This impacts those funds that are legitimately generated but do not adequately fit the narrow 'allowable source' definition. The inability to repatriate these funds reduces the available capital domestically, and limits growth of off-shore Chinese entities. We understand that policy makers are currently working to develop a solution to this challenge.

Recommendation:

Chinese entities who generate offshore RMB capital could engage with policy makers to with a view to developing a wider set of parameters for allowable capital inflow.

Benefit:

The Chinese financial market would benefit from the increased capital inflow. The liberalised framework would reduce issues around legitimacy of capital repatriation and increase market efficiency.

Observation 9: Impact of RMB exchange rate margins on new business in China

A number of Australian businesses are exploring setting up operations in China. Most recently, this has been aided by the strength of the Australian dollar. However, the limited liquidity of the RMB, its limited availability and restrictions around foreign exchange services cause a potential obstacle to these businesses.

Recommendation:

A controlled yet more flexible foreign exchange conversion could be made available within certain cities or certain sectors. This would give foreign investors in these sectors greater incentive to inject capital, while being able to manage their foreign exchange conversions more efficiently.

Benefit:

While establishing a smoother path in the plan towards RMB internationalisation, the additional benefit is of expansion of trade and industry.

Observation 10: Revisions to Securities Investment Funds law

As highlighted in the 2011 White Paper, the 2004 Securities Investment Funds Law of China continues to be inconsistent with the more recent regulations and market developments. Chinese investors cannot invest outbound to overseas fund products freely, nor can overseas fund managers market their fund products in China freely. The QDII scheme is merely an approved channel for Chinese investors to access overseas security markets, but does not permit overseas fund managers to market their products in China via the scheme.

The revised Securities Investment Fund Distribution Administrative Measures of June 2011 lifted the restriction on the ability of locally incorporated foreign banks' to engage in agency activities for local fund distribution. However, no fund distribution licence to foreign banks has yet been granted by the China Securities Regulatory Commission (CSRC).

Recommendation:

As identified previously, a clear set of rules is required on how Australian fund managers can work within the QDII scheme in promoting their products to the domestic Chinese investor. Further, utilising their experience from the Australian funds management model, Australian fund managers could provide insight and share knowledge with the Chinese funds managers and regulators on the potential strategies to develop the domestic sector.

Benefit:

Clear protocols around the administration of the QDII scheme would encourage further growth in the funds management sector, encouraging greater participation by Chinese investors, Chinese fund managers and Australian fund managers. Building capability of Chinese participants through engagement with their Australian counterparts, will boost the development of the sector.

Observation 11: Cap on foreign stake in JV fund management

Currently, a foreign shareholder can only hold up to 49 per cent stake of a joint venture (JV) fund management company in China, which is not a controlling interest. Statistics show that JV fund management companies do not outperform their domestic peers in general.

Recommendation:

Remove the cap on equity interest of foreign shareholders and allow foreign shareholders to hold a controlling interest of the JV fund management company. This will help to streamline the company's management approach and development strategy.

Benefit:

Australian funds managers can share their expertise in fund distribution business with the Chinese market and offer the Chinese investors a wider range of investment options. Additionally, foreign fund managers will be encouraged to stabilise their holdings in the Chinese investment management industry.

Observation 12:
Development of more sophisticated investment products

The current policy move away from reliance on bank deposits and lending to a diversified range of loan and investment financial products is a welcome move, allowing Chinese investors access to more sophisticated, high yielding and longer-term investment and instruments. However there is a lack of experience in establishing the framework to support this demand, and the current available investments options are limited and immature.

Recommendation:

Partnering and engagement between China's domestic insurance and investment companies and the Australian institutions is recommended, to gain insight from the Australian institutions on their extensive product manufacturing capabilities and expertise in critical areas such as fee income generation, credit risk assessment and cross selling of products and asset management.

Benefit:

With the support of the mature Australian funds management sector, China's transition to these more sophisticated financial instruments can be managed in a smooth, planned manner, minimising risk and applying the controls and incentives to instigate growth.

Observation 13:
Opening up of the bond market

We encourage China's policy makers to continue efforts to further develop the government and corporate bond markets. This reform is widely acknowledged as being a necessary step in the reform process, bringing with it the security, financial backing, structure and liquidity that are essential to a mature financial market. At present, domestic financial institutions in China have limited experience in developing and operating a corporate bond market.

Recommendation:

Chinese policy makers and institutions could engage with Australian institutions in order to understand and capitalise on their expertise in areas such as the origination of fixed income products and services. This coupled with the Chinese banks' local knowledge and distribution capabilities, would ensure a successful transition to the domestic bond market.

Benefit:

Utilising the knowledge and experience of the Australian institutions will ensure that the opening up of the bond market meets global standards, and is implemented with the appropriate financial market considerations.

Observation 14: QFII application process timeliness

Applications for QFII status can vary in timeframe with a potential 2-year time horizon. The uncertainty caused by lack of transparency and explanation of the estimated time for QFII application approvals, has a flow-on impact to the funds' business operations. When additional QFII quotas are required, similar timeline challenges cause further uncertainty.

Recommendation:

CSRC and SAFE should provide clarity and explanation about the time constraints and regulatory requirements of the QFII application process, at the commencement of the application. This approach would enable the applicant to include the estimated application time in their business planning, and would also facilitate valuable dialogue between the fund manager and the policy makers on an ongoing basis.

Benefit:

This more transparent and clear QFII application process would result in greater interest in QFII investment. Establishing an approach of greater dialogue between the policy makers and the funds managers would benefit the sector expansion.

Observation 15: Domestic funds distribution dominated by large state-owned enterprise

Large state-owned banks dominate the domestic funds management sector. As a result, funds distribution is limited to these participants, and other fund managers are required to pay substantial distribution fees to these participants.

Recommendation:

CSRC could gradually introduce a wider distribution channel network, aligned with the strength of all fund managers operating in the market. As an interim measure, policy makers could monitor the distribution fees structure applied by the dominant participants, to ensure that the fees do not become an inhibitor to the sector's growth.

Benefit:

A wider distribution capability would result in a more balanced and diversified funds management sector, which as a result would provide more liquidity and create more demand for local stocks.

Sector specific recommendations
Trust companies & Securities companies

The issue, in April 2011, of the revised Foreign Investment Catalogue did not change the restrictions on access to the securities, trusts and funds management sector. With the emphasis by China's policy makers on the development of a more balanced financial market, it was disappointing that the barriers to entry remain restricted.

Observation 16:
Limitation on ownership stake in trusts / JVs impacts investment attractiveness and operational benefits

The current allowable ownership limit for a foreign institution investing in trusts in China is 20 per cent, to a maximum of 25 per cent cap on total foreign holding. This level inhibits true engagement and active involvement from the foreign investor, thereby reducing the attractiveness of this investment approach as well as limiting the value to the Chinese investee.

The same benefits would apply to the securities industry where foreign participation is limited to 33 per cent.

Recommendation:

The ownership limit should be increased to a controlling interest level. This would allow investors to gain the appropriate level of returns on their investment and would ensure that the investor is committed to the venture through, for example, the provision of expertise and know-how that is commensurate with their ownership stake. This would result in the JV / investee company gaining the knowledge and experience of a mature and international investor.

Benefit:

By allowing foreign investors to hold a larger ownership stake in Chinese non-banking organisations, such as trusts and similar JVs, the investee entity can increase its access to international experience, systems and knowledge; and in doing so, it would accelerate the maturing and growth of this sector. By aiding the development and maturing of the trust company and security company sectors' through greater foreign participation, China will achieve a more innovative, and balanced financial services sector where there is improved efficiency in capital allocation.

Observation 17:
Opportunity to create a wholesale funding market for foreign banks to access domestic funding

As foreign banks expand their activities in the domestic China market, they are hindered by their inability to source the same level of significantly lower cost funding which is available to local banks via local depositors.

Recommendation:

Policy makers could develop a planned approach using trust companies to manage securitised local corporate bonds in conjunction with domestic financial institutions. They could leverage the experience of the foreign banks that have addressed similar 'market development' dynamics in other markets. A robust ratings agency would be required (foreign or domestic) to rate the Chinese corporate bonds as part of the securitisation. This is in alignment with the Chinese Government objectives of allocating capital more efficiently and allowing non-state owned entities to access capital more cheaply and efficiently.

Benefit:

Establishing this securitisation of local corporate bonds introduces a new flow of capital to the domestic financial market, thereby increasing market growth and maturity. The increased participation of foreign banks in this domestic corporate bond market injects additional capital to the specific areas that need it. A greater level of competitiveness for all market participants will drive more capital allocation efficiency across the market.

Sector specific recommendations
Private Equity

Chinese private equity (PE) fund managers, growth stage companies, and the broader Chinese economy, could benefit substantially if the opening of China's private equity marketplace to Australian investors is pursued.

Observation 18: Regulatory transparency and clarity is lacking

There continues to be a lack of clarity and transparency regarding the legislative and regulatory requirements for foreign PE investors to establish and operate private equity funds in China. This may be largely due to the regulatory regime still being under development (as evidenced by the 'Shanghai Pilot PE Fund'). However, until the regulatory regime is more clearly and comprehensively articulated, it remains challenging for Australian private equity funds and capital to engage in the China market.

Recommendation:

The policy makers could engage with the Chinese and foreign private equity participants to gain a broad understanding of their issues and suggestions. They could also take advantage of Australian and other international knowledge and expertise in structuring the regulatory regime. Understanding the history of, and strategy behind, the development of regulatory frameworks of foreign jurisdictions would be a valuable reference point. To ensure greater understanding of and adherence to regulation, the policy makers could circulate regulatory updates and guidelines.

Benefit:

Increasing the level and pace of transparency around private equity regulation, would benefit Chinese policy makers by creating a closer relationship with the domestic and foreign private equity investors. More transparent regulatory framework would compel greater adherence to the regulatory requirements and minimise activity that could disrupt the sector.

Observation 19: Structural barriers to Australian private equity investment

There are continuing restrictions on foreign capital investment in onshore RMB PE funds and restrictions (or perceived restrictions) on repatriating investment earnings to the investor's home jurisdiction. Additionally, there are limited structural options for Australian PE funds to establish RMB fund partnerships or entities in China. There are high minimum capital requirements for foreign Limited Partners (USD500 million) to qualify to invest in the 'Shanghai Pilot PE Fund' structures; as well as ongoing industry restrictions (for example high tech sector), which limit private equity investment.

Recommendation:

Policy makers could consider raising the priority and pace of opening up the PE market with specific initiatives around the 'Shanghai Pilot PE Fund' program, and could use this as a showcase sector for international collaboration. A possible initiative might be to reduce the capital requirements of foreign PE investors, to encourage the entry of more mid-market PE investors into China.

A standing consultative mechanism between the Chinese policy makers, domestic and international PE investors could be established, with the goals of increasing dialogue and growing a shared knowledge of objectives and issues. It would be valuable to increase the importance of PE reforms within the overall financial reform process.

Benefit:

China could take advantage of the current high interest in and inflow of PE capital and new foreign-invested PE funds being established in China. By engaging with foreign PE participants on sector reform, China's PE sector would benefit from greater internationalisation of investment processes and financial reporting standards. The open dialogue of expertise and know-how between Chinese, Australian and foreign private equity fund managers, would accelerate the overall development plan for the sector, and would increase expansion opportunities for Chinese and foreign private equity investors.

Sector specific recommendations
Insurance

While foreign participation in China's insurance sector is still relatively restricted, there are opportunities for its expansion via engagement with other mature insurance sectors in the region. There would be substantial benefits for the Chinese consumer from expansion, including a wider range of product offerings and greater protection through stronger insurance policies.

Observation 20: Different approval treatments between domestic and foreign insurers.

Currently a wide difference in treatment of policy and procedures for insurance companies is apparent for domestic insurers and foreign invested insurers. There is a lack of uniformity of policy from various sections of government (central, provincial, municipal and city local). For example, approval of new provincial branches is restricted to one new branch approval per single application for foreign joint venture insurance companies, while for domestic insurers, there is no such requirement and China Insurance Regulatory Commission (CIRC) may approve multiple new provincial branches for domestic insurers in one single application. The foreign JV insurer can only apply for a second branch, upon CIRC approval of commencement of business for the first branch, thus limiting to 2-3 new branches per year for foreign JVs.

Recommendation:

CIRC could allow foreign insurers to lodge up to 3 new provincial branch applications at a time (instead of one). CIRC can control the application pipeline by placing limits, such as allowing further applications after branches under application have been approved for business, or after the submission time for the last application has exceeded 4 months.

Benefit:

By supporting the investment interest of foreign insurers, the sector will benefit by better development of staff and distribution resources and stronger engagement between domestic and foreign insurers with a common goal of growing the sector. This engagement will accelerate the sophistication and capability of the insurance sector in China and in doing so, will build a strong prudential foundation.

Observation 21: Insurance sector in China is in its infancy and has limited capability in its current structure

Current insurance investment options are limited to China mainland. This limits insurance product options for customers as well as limiting the sector from operating on par with international standards.

Recommendation:

CIRC could consider allowing insurers to use Hong Kong as an additional asset management pool, to diversify its insurance asset management. This will help to create more insurance product choices for consumers, and also help the industry to align with worldwide practices. Hong Kong has mature, world-class asset management capabilities and vehicles that can be used for insurance fund management, which could be leveraged for China's benefit.

Benefit:

Insurance customers will benefit through a broader portfolio of insurance products and the assurance of dealing with insurers who operate on a more diversified asset base. Policy makers would benefit from leveraging the knowledge and framework of more mature, well-established asset management markets.

Sector specific recommendations
Advisory services supporting the Financial Services sector

Consulting and advisory services supporting the financial services sector encounter a set of inhibitors to their ability to fully service the financial institutions in China. Of these, the 2011 White Paper highlighted the need for an accreditation or certification that would be provided via a "bridging or conversion validation" for professionals trained in Australia who are supporting Australian and Chinese financial services organisations in China.

Observation 22:
Cost margins for specialist financial institutions advisors

Financial services organisations operating in China, both Chinese and Australian, regularly seek the advice and engagement of specialist consultants. In particular, the focus is on sharing learnings from the mature Australian financial services sector with a view to building knowledge of international markets.

A key factor for implementing such shared learning projects, is to deliver the right level of expertise from Australian financial institutions. However, the challenge continues to be the lack of acceptable 'fee for service' arrangements and perception of acceptable margins for this expert advice. Similarly, the collection of fees and the resulting debts becomes an ongoing concern. These factors create an operating barrier to obtaining expert advice.

The result is that it is uneconomic to bring Australian professionals to China for consulting engagements and knowledge transfer. This challenge is further exacerbated by the high value of the Australian dollar, resulting in a comparative price disadvantage, thus limiting the ability to support the domestic financial services sector.

Recommendation:

Engage with key financial services organisations in China to agree a workable model that is acceptable economically to all parties; and which includes a number of alternative approaches, such as travel to Australia or travel to China, financial support by key Government / regulatory / education bodies in Australia and China or co-development with key academic institutions.

Policy makers could include advisory firms in the working groups that are tasked with planning for the development of the financial services sector. These advisory firms can contribute experience and knowledge about regulatory frameworks that have been implemented in other international jurisdictions, for example, the planned introduction of Solvency II and Basel III.

Benefit:

Chinese financial services organisations will be assured of continued knowledge sharing and co-development of best practice methodologies. In light of the financial instability of other geographic regions, Chinese and Australian financial services organisations have the assurance of working with stable and robust regional partners to further the growth of the sector.

Appendix

Overview of Australian banking investments in China

Australia and New Zealand Banking Group Limited (ANZ)

In China Since	Infrastructure	Business scope	Partnership
1994	> Local incorporation Oct 2010 > 4 branches, in Shanghai, Beijing, Guangzhou and Chongqing > 2 sub-branches > 1 rural bank in Liangping	> Corporate Banking > Commodity & Trade Finance > Markets > Retail	> 20% stake in Tianjin City Commercial Bank > 20% stake in Shanghai Rural Commercial Bank

Commonwealth Bank of Australia (CBA)

In China Since	Infrastructure	Business scope	Partnership
1982	> 1 branch in Shanghai > 1 rep-office in Beijing > 4 country banks in Henan (80%)	> National funds license in Shenzhen > Foreign life insurance license in Shanghai > Corporate and institutional banking > Trade finance	> 20% stake in Qilu Bank > 19.9% stake in Bank of Hangzhou > Colonial First State Global Asset Management 46% of First State Cinda Fund Management Co Ltd. > BoCommLife Insurance Company (37.5:62.5 JV between CBA and BoCom)

National Australia Bank (NAB)

In China Since	Infrastructure	Business scope	Partnership
1986	> 1 branch in Shanghai > 1 rep-office in Beijing	> Corporate and institutional banking > Commodity & Trade finance > Markets	> 20% state in China International Industrial Trust

Westpac Banking Corporation (Westpac)

In China Since	Infrastructure	Business scope	Partnership
1982	> 1 branch in Shanghai with RMB licence > 1 branch in Beijing	> Corporate and institutional banking > Trade Finance	> n/a

Macquarie Bank Limited (Macquarie)

In China Since	Infrastructure	Business scope	Partnership
1995	> 1 rep-office in Shanghai > 1 rep-office in Beijing	> Investment Banking > Corporate Finance and Advisory > Corporate and Asset Finance (Leasing) > Securities Research > Environmental Finance Products > Principal Investments	> 20% state in Sino Australian Trust Company with State Development and Investment Corporation > Macquarie China Everbright Infrastructure Fund > MWREF > MCRC

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