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### **View from Hong Kong Feb 14-17, 2017**

#### **Executive Summary**

Hong Kong is experiencing an identity crisis. The city that has prided itself first on independent capitalism at the heart of Asia under British rule, then on being a gateway to China after the handover to China in 1997 is now, 20 years on, unsure of its next steps. It has become an important financial centre with an international stock market, robust foreign exchange market and a bond and derivative marketplace that supports modern financial management requirements for multinational companies and regional businesses alike. However with China's influence growing and uncertainty increasing regarding Hong Kong's status as preeminent financial centre in China's One Country Two Systems, the city is unfocused.

With more than 630 UK companies having a presence in Hong Kong and holding the 15th largest market for UK exports, it is no surprise that news on Brexit is of great interest. However, largely, Hong Kong sees itself as a net-winner in the aftermath of Brexit for financial services.

Hot topics outside March's domestic elections and global politics include Hong Kong Stock Exchange connections, FinTech and Belt and Road Financing.

#### **Further Detailed Notes:**

##### **Identity crisis meets "mainlandification"**

Hong Kong's journey from unique Asian financial hub to a future within China is forcing an uncomfortable look in the mirror for its Financial Services industry. Add to this the imminent elections for a leader to succeed C Y Leung set for March 26th, and the uncertainty becomes a very strong backdrop with little in the way of bold foreground. China's influence and Hong Kong's ebbing identity is exemplified by the elections. In essence it is a two horse race – one horse clearly backed by Beijing and the other the popular choice. It is a very interesting time for testing the extent of the independence offered by China's plans to let Hong Kong retain its system after the British handover. Currently Hong Kong offers rule of law, low taxation, talent attraction through its liberal social policies, negligible barriers to entry for trade and investment. Those in Hong Kong are worried these tenets of their economy are slowly and invisibly changing. Next stop just another Chinese city with a financial centre? It is easy to see why "mainlandification" is a hot topic...albeit often discussed in a hushed tone for fear of who may be listening on the next table.

## **Brexit**

News on Brexit is in demand. Hong Kong is the UK's 15th largest trade partner the majority of which is services. Currently 630 British firms have a base in Hong Kong (of which 130 are designated Asian HQ's) and much of the activity is in financial and professional services. The market wants to know where we will end up on our access to Europe – what will the deal look like – particularly for Financial and Professional services firms? Already being a global financial centre, Hong Kong can be a net gainer from Brexit should firms consider shifting resource out of London. This is particularly true for trading, foreign exchange and fund management. We would do well to lift our eyes further east when debating who amongst Frankfurt, Dublin, Paris or Luxembourg will be a rival for London's talent. If volumes are the hallmark of a winning financial centre we ignore Hong Kong at our peril particularly as the world pivots to the East geopolitically. Even more importantly as our journey through Brexit imminently commences, London should prioritise deals with Hong Kong that can help it through its identity crisis in a way that compliments not conflicts with London's position.

## **Financial Connects to the Mainland**

The Heng Seng Index remains bullish reaching over 24000 (highest levels since summer 2015). Markets are becoming ever more linked to the Chinese mainland. The Hong Kong/Shanghai Stock Connect is attracting higher daily volumes both northbound and southbound, and the Shenzhen/Hong Kong Stock Connect launched in early December is live (albeit with minimal traffic). Hong Kong enjoys a mutual recognition of funds (MRF) regime with mainland China allowing funds to be sold cross border. Hong Kong remains number 1 for offshore RMB pooling, however, with the bearish sentiments for RMB valuation this pool is eroding.

In terms of bold strategies Hong Kong has robustly supported China's Belt and Road initiative and has staked a claim to being the Belt and Road global financing centre. The market is less enthusiastic than the leadership. Much of Belt and Road financing will come in the form of bonds and while Hong Kong has a large bond market, its depth and breadth pale in comparison to Asian rival, Singapore. However, as ties to China continue to build (there are rumours of a bond connect with HKEx and China's CFETS), the City of London must not be complacent where our aspirations as a Belt and Road Financing hub are concerned.

## **Green is not the new black**

Notably in Hong Kong the topic of Green Finance is almost wholly lacking buy-in. While London is a clear leader in Green Finance both in policy development and practical product, Hong Kong is sceptical at best and scathing at worst. The refrain I heard from market participants at all levels was "show me the money". Green finance (for the moment a proxy for green bonds), is seen as more expensive and lacking in investor demand. It is possible the green agenda will gain traction with investor interest in expanding their Green portfolios to equities and funds (Hong Kong's stronger suit). Best not to hold your breath. This gives London a clear head start and leadership position. As infrastructure finance continues to develop via the

Belt and Road initiative and beyond, sustainability will play an important role and London's advantage could be an ace up our sleeve.

## **FinTech**

Hong Kong prides itself on being a FinTech hub. Hong Kong Monetary Authority (HKMA) are robustly supportive and robustly cautious. There is indeed a lot of talk about FinTech in the city. Talk. And advisory. And did I mention the talk? Hong Kong is again finding its space in this market between China's runaway FinTech market and Singapore's MAS regulate-to-stifle environment. Links to London would be useful for Hong Kong and it wouldn't surprise anyone if a FinTech bridge was imminently announced.

**View from China**  
**Feb 20-25, 2017**

**Executive Summary**

As China publically downgrades its GDP growth forecasts to 6.5%, the country is continuing to prioritise stability. Primarily this is due to distraction in the lead up to the 19th Party Congress in October of this year where there will be a shuffle at the Chinese top table. As the political manoeuvring continues, radical reform, restructuring or opening up is unlikely. RMB internationalisation is firmly on the backburner and capital outflows are under house arrest. The Chinese currency's valuation has recently stabilised, but this is less to do with market forces and more attributable to Chinese government intervention. Inbound flows on the other hand are being courted via many routes including the recently opened interbank bond market and the Panda bond market.

Financial innovations are being embraced and tracked closely by regulators. FinTech and Green Finance are both big business in China and an area the UK is a close partner. Other innovations are moving slowly – including the London-Shanghai Stock Connect which is continuing its feasibility study which hopefully addresses both technical details and investor education.

Post Brexit Britain remains a financial services partner of choice for China, but caution is being exercised. We have China's very long term time horizons in our corner, but could use this time wisely to add to our appeal by supporting China's priorities including financing for Xi's Belt & Road initiative and global Green Finance leadership.

**Further Detailed Notes:**

**Chinese Musical Chairs**

President Xi's first 5 year term as Party leader will conclude at October's 19th Party Congress and his next 5 year term will begin. Between now and then the country will be distracted by the jostling of domestic players to get in position for the seats on the politburo and standing committee when the music stops. The result of this is a strong focus on stability and radical changes, reforms or regulatory surprises are unlikely. Of course, Xi is also China's President and this governmental term renews in March 2018, however, the results of October's congress will clearly define the governmental landscape to come.

In the meantime, structural and economic reforms at all levels are glacially slow. Key positions have already been shifted in advance of October as evidenced by Beijing, Shanghai and Tianjin mayors all being new to the job. This visit was a first opportunity to connect to these important city mayors who uniformly supported freer trade particularly in services with the UK. The devil will as always be in the detail.

## **Annoying Brexit**

I have been reliably informed there are more Chinese banks in London than any other city in the world save Shanghai. Therefore it is no wonder that the implications of Brexit are of great interest to Chinese stakeholders. China has made a strategic and strong investment in London and, unlike other major inward investors in the City, this reflects both a commercial and political interest. China's largest 5 banks are state-owned (SOEs) which require a green light from the government to invest abroad. Above and beyond banks, many of the largest financial institutions in China are SOEs and have made commitments via offices and investment in London. The Chinese do not want to see these investments lose real or strategic value.

However, we are not the only country on China's European dance card. All of China's banks have branches and subsidiaries elsewhere in Europe. This allows them to be relatively sanguine about Brexit and worries about access are in general not critical (notable exception in Asset Management sector where clear Brexit guidance is being actively requested). China thinks long term. They are committed to London and strongly believe its position as the largest offshore RMB hub outside of Asia is secure. The uncertainty our vote to leave the EU has created is unwelcome, annoying and baffling in equal measures. But China's commitment to the City remains unwavering. For now.

## **RMB Internationalisation is dead. Long live RMB Internationalisation.**

You could argue Brexit gives China a useful excuse for the slowing of the RMB Internationalisation agenda in London. The fact is the RMB is falling and the market is full of bears that predict further depreciation. In 2012 simply holding RMB denominated products guaranteed a >10% return. Now that trend is reversed.

As is oft the case, China has defaulted to regulatory tightening in order to maintain control. Capital outflow restrictions put into place in December of last year are taking hold. Some outbound deals in areas of core business are still moving forward, but dreams of football teams, hotels and landmark properties are being put asunder. In more pointed terms, QDII and QDLP schemes for outbound investment have dried up. Industry and government pundits agree that this will likely continue for some time.

Trade use of RMB is declining as well. Ascending to 5th place in the global trade currency ranking in 2015, the RMB has now slipped to 6th place. Notable, but in reality RMB being held by corporate treasurers in this way is still tiny. The real investors are playing in RMB products such as bonds and ETFs. Derivatives and commodities priced in RMB are still thin on the ground.

On the other hand, RMB inflows are "open for business". China's interbank bond market flung open its quota-free doors for foreign investors in the world's 3rd largest bond market in April of last year. China is looking beyond RQFII and QFII to attract the world's investors. That uptake is growing – particularly in the area of accessing F/X pairs products and medium term government backed bonds. With PBoC offering rates of 4.35% compared to Bank of England's 0.25%, the sting of RMB depreciation can be somewhat tempered.

## **How have the Shanghai-HK and Shenzhen-HK Connect escaped controls?**

Since the Shenzhen-HK Stock Connect opened on December 5th, China has 2 live stock market connections. Both programmes work under a quota system both northbound and southbound and have similar structure and attributes while the underlying stocks on the two mainland exchanges are very different. Shenzhen is China's Nasdaq while Shanghai is its NYSE. The launch of Shenzhen broadens foreign investor's options and exposure to Chinese growth stories, but volumes are predictably low and it is early days.

Importantly, there is no risk of capital outflows in these existing connects. They run on a closed loop system that allows exposure and participation before any capital and profits (or minus losses) are returned to the country of origin. A leak-free system.

London and Shanghai are also discussing a "Connect". It will be a very different format to the existing Connects – it has to be with a massive 8 hour time difference leaving little opening hour overlap between the centres. However, some say the technical, regulatory, clearing and logistical challenges pale in comparison to the practical. Who is going to use a London-Shanghai Connect? We know from watching the HK vanguard programmes that Chinese investors are like investors worldwide. They invest in what they know. The stocks with most southbound volume mid 2016 were Beijing Jingcheng Machinery Electric and Dalian Port. Not Burberry and HSBC. Investor education and demand building will be an important factor in any London Shanghai connect.

## **Pandas Eating Dim Sum**

As offshore RMB wanes, China hopes its onshore RMB attracts investors. Promotion of offshore RMB denominated bonds (Dim Sum bonds) is being replaced with talk of onshore RMB bonds by foreign issuers (Panda bonds). However, this market has its challenges. Foreign issuers are met with a series of hurdles to issuance including differences in accounting standards and an opaque approval process and timeline. Issuers also need to come to terms with raising capital in a market that currently traps those funds in mainland China.

Nonetheless, British banks are ready to step forward and bring foreign issuers to market. If the 8th UK China EFD promises come good, they can do so as full primary underwriters. A win for all parties.

## **Redrawing the Belt & Road map**

President Xi's Belt & Road Initiative is not news. Its ambitious plans were unveiled in September 2013. What is news is Xi's geopolitical gathering set for May to gather the leaders of countries along the Belt & Road to Beijing for the first official pow wow on the topic. This is illustrative of China's growing role as convenor and world leader. It is also a reminder of the powerful drivers in China to solve its domestic oversupply issue, create stronger trade links with countries near and far, and build security through soft power.

London does not feature on Xi's Belt & Road map specifically (although I have seen a version that ended in Manchester – during the heady days of Northern Powerhouse pitches). However, London can play a critical role in Belt & Road success. Massive infrastructure projects require deep pools of patient capital looking to match long dated liabilities with long dated returns. London is a mecca for this sort of investor so it is a natural fit to become a (the?) hub for Belt & Road financing. The UK's early support of the AIIB still garners appreciation, and our involvement in supporting Xi's primary development strategy could do the same. The challenge as always is to make infrastructure investment efficient. London leading on a Belt & Road asset class definition could be the thin end of the wedge to establish London as the world's go-to primary and secondary markets for infrastructure assets.

## **Green Finance**

China is already the world's largest green bond market. Through the joint work during last year's G20 Green Finance workstream, the UK has become China's partner of choice in defining, growing and monitoring the green finance industry. A staggering 20% of investments in China need to be "green" for China to meet its national objectives on climate issues including the dreadful pollution plaguing many Chinese cities. In the face of this home grown plague, China has embraced green finance as a tool to clean up its act. All the time stability remains China's top priority, Green Finance also helps to quell social unrest through mitigating growing tensions from the public regarding negative impacts on health.

China's appetite for green bonds sees no sign of abating but there is certainly work to be done to ensure alignment of China's definition of green with emerging global standards. It is a logical next step for China to embrace other forms of finance going green – asset management products, equities, indexes. Indeed "Greening" the Belt & Road surely is a welcome union of two of China's priorities.

## **China is the world leader in FinTech**

The UK is the world leader in FinTech. So is China. These statements are both true. Where China leads the world on the consumer end of the FinTech value chain and in mobile payments and micro investing, the UK leads in mature financial market innovations such as Regtech and Insurtech and use of blockchain. There is a lot of excitement about collaboration in FinTech between the UK and China, but there is also a lot of information asymmetry. We're talking different languages in many cases. China's FinTech scene is dominated by tech giants – Alibaba Group, Tencent, Baidu, JD, Lufax. FinTech in China has volumes our FinTech scene in the UK would die for (for example, 200M WeChat wallet users growing rapidly towards WeChat's 818M monthly active user base). UK FinTech has deep experience in cross border flows China can only guess at. There is work needed to create a bridge to find ways to trade, invest and localise.

Lo and behold a FinTech bridge was born. In November the UK and China announced a FinTech bridge to provide a platform for collaboration. A bridge is only as good as the traffic on it. Currently regulators collaboration potentially leading to a

Chinese regulatory “sandbox” is providing early traffic. What will hopefully follow is business footfall.



**View from India**  
**Series of Visits Feb/April**

**Executive Summary**

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**Further Detailed Notes:**

**7 More Years?**

After Modi's BJP landslide win in Uttar Pradesh on March 11th, many sources are heralding 7 years of continued politics led by Modi. This would mean success in the 2019 elections and a second term for a leader who is putting the economic reform as a central pillar to his platform. This is good news for business which would embrace stability and certainty on the macro trends for India's economy. Modi has led his party to be the first in 3 decades to secure a majority – and the win in UP has been seen as nothing short of a unprecedented renewal of mandate midway through his first term.

There is talk of shifting to a time of execution and a trend to opening up and looking out. This may be wishful thinking but some evidence suggests some early steps in this direction. The efforts by the province Tamil Nadu in London to explore infrastructure funding has not gone unnoticed.

However, this is a rapidly evolving India. It would be unwise to predict what will happen a full 2 years from now in politics which have not had a robust history of predictability (arguably in a world recently also missing a political crystal ball).

Political stability and economic agenda would go a long way to harnessing India's domestic GDP growth to become a stronger player on the world stage. India pipped China to the GDP growth post earlier this year announcing 7.6% growth versus China's 6.9% (vs 2015).

### **The Unprecedented Case of Demonetisation**

Overseeing a riot-free transition of 80% of a country's currency to new notes (and even new sized notes!) affecting 1.3Bn people domestically is nothing short of miraculous. Of course there were stories of queues and chaos for a few days when payments were impossible. More colourful stories about 5 star hotel luxury shops flooded with cash buyers loading up on designer handbags and jewellery were also forthcoming. Indeed 6 months on from the November 8th surprise announcement of all 500 Rupee and 1000 Rupee banknotes being invalidated by midnight, the impacts on the economy are still being reviewed. Remarkable.

Modi's rationale for the move on day one differed from his message on day 7 after the announcement. Initial rationale squarely centred on rooting out black money and corrupt fat cats turned swiftly when returns of banknotes significantly surpassed expected volumes (in the end 97% returned). The narrative turned to digitising the economy, bringing the unbanked into the modern world, and FinTech.

Some significant byproducts of demonetisation to watch going forward are indeed the new visibility of deposits in the banking system that can support India's plans for FinTech. Furthermore, demonetisation pulls much of the economy particularly in rural areas out of the shadows allowing taxation to be implemented more effectively. Finally, the fact that more cash was returned than expected means no windfall for the government – and no bag of cash to spend on government programmes.

### **Financial Inclusion Driving FinTech**

India's been the world's technology backoffice for decades. It seems now in the world of FinTech it is taking bold steps to be an innovator themselves. There are some usual narratives about emerging economies leapfrogging mature markets, but rarely is government so involved in turning that narrative into reality.

Aadhaar is a 12 digit unique-identity number issued to all Indian residents based on their biometric and demographic data. The data is collected by the Unique Identification Authority of India (UIDAI), a statutory authority established on 12 July 2016 by the Government of India. It is already the world's largest biometric ID system with over 1.13Bn members enrolled as of end of March 2017. On top of this the government department has developed a technology stack that is open to developers to create applications and usage for this sophisticated system.

This is not a pet project of India's tech sector – Minister of Finance Jaitley has been preaching his support for this initiative at home and abroad. His visit to London in March championed this discussion and along with him was a delegation from India's FinTech and Telecoms sector. This was reciprocated during the UK India Economic and Financial Dialogue held in early April led by UK Chancellor Hammond. UK's

FinTech leaders descended on Mumbai to talk collaboration with a market tantalisingly a billion users strong.

### **You can't talk about India without talking about NPAs**

India's Non Performing Asset problem is creating a banking log-jam. Current estimates suggest 8% of India's GDP is in stressed assets. In most countries this would constitute a banking crisis, but with a banking sector so strongly backed by the public sector, India has been able to avoid this through an extend and pretend strategy. Change is coming in the form of the new bankruptcy law which allows the real possibility of transferring these assets to companies that can engineer change.

It is important to not focus completely on the rear view mirror when considering India's banking sector. Currently 80% of NPAs are in power, infrastructure, textiles and metals sectors. This explains the current power oversupply situation in India to some extent (thankfully being alleviated slowly by improved infrastructure to distribute power across the country). However the question of where banks should prioritise lending going forward is an important consideration to ensure the NPA situation is not exacerbated.

There is no easy solution. Private banks are in a much better place than public banks. Discussions regarding the creation of a "bad bank" continues. Foreign ownership of ARC's (asset reconstruction companies) is welcome. Lets hope foreign investors do not inherit a very complicated problem.

### **What is higher than gold standard?**

It is a question Indian investors seem to be asking when making investments. Anything less than AAA rating is deemed as junk bonds. And with government bond yields hovering just below 7% who would blame them? However, this causes knock on effects for an underdeveloped corporate bond market and money flowing to infrastructure projects the country needs to grow.

UK and India have agreed at April's EFD meeting to invest \$120M each in an NIIF sub-fund focussed on renewable energy. Certainly a good way to kickstart investment in important infrastructure development and one to watch in terms of if private sector involvement falls in behind. However, the issue does not seem to be finding money for bankable infrastructure projects. Too often the painful process of bureaucratic delays in approving projects is compounded by endless struggles to secure land rights. Fix this and there is money onshore and offshore to build what India needs.

### **Masala Bonds and Rupee Internationalisation**

London is home to 80% of the world's Masala bonds – rupee denominated bonds listed offshore. HDFC issued in March the world's largest Masala bond and was two times oversubscribed. Not only is this good for London and issuers like HDFC, it is good for the bigger picture of the internationalisation of the Rupee.

India's central bank, RBI, has long been wary of discussing or even admitting the existence of offshore Rupee transactions. This year's UK India EFD made a significant breakthrough that both countries supported the City of London's plans to create a Rupee Internationalisation Initiative to build on the excellent work of the India UK Financial Partnership (IUKFP). Through experience in other emerging currencies, London's #1 status in foreign exchange, and the roadmap of the IUKFP, the aim is to work closely with India to develop the offshore Rupee market.

An important collaborator and competitor in the efforts to internationalise the Rupee is Singapore. Also home to Masala bond issuance and a robust NDF market in Rupees, Singapore can also be a centre to develop this emerging currency. The first step is to encourage pooling of offshore Rupee to drive demand for innovative financial products to meet the need of investors seeking exposure to the Indian market. That first step, and the next and so on will likely be slow. But working together with India will ensure London can both teach and learn.