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The Development, Role, and Influence of the Qualified Foreign Institutional Investor System

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As a way for a developing economy to attract foreign capital and open up capital markets at a time when there's no full currency convertibility and no open capital account, the Qualified Foreign Institutional Investor (QFII) system was implemented in several emerging markets, first in Taiwan, followed by Brazil, Thailand, South Korea, Malaysia, and India. China implemented QFII in November of 2002. Recently, China announced the cancellation of QFII limits, the approval process for individual institutions, and RQFII pilot countries (or regions), marking a new chapter in the opening up of China's capital markets. This paper intends to start from the development process of the QFII system in Mainland China, analyze its main functions, and explore the influence and prospects of reform and the role of Hong Kong.

I. QFII Process in China: Development and Improvement

The opening of China's capital market is a process of building a market system through markets and internationalization, and is constantly converging with international regulations and rules. It is also a process that is two-way, gradual, and within risk limits. QFII is an important example of "bringing in", and its development has witnessed the whole process of China's capital market opening from scratch to a smoothly and orderly state. To sort out the historical context of the development of QFII in China, the author divides it into four main stages:

1. Start and suspension (2002-2006). After China's stock market became the most dynamic Asia-Pacific market in 10 years of development, " Provisional Measures on Administration of Domestic Securities Investments of Qualified Foreign Institutional Investors (QFII)" was issued in November of 2002. The initial limit was only US$ 4 billion. The following year, in July, QFII's first transaction was completed, and the system was officially operational. In August of 2006, relevant management measures were introduced, along with the entry of retirement funds, charity funds, endowment funds, trust companies, and government funds. By the end of the year, due to the US$ 10 billion restrictions, QFII approval was suspended.

2. Restart and innovation (2007-2011). In October of 2007, QFII restarted new approvals, and the year-end limit went up to US$ 30 billion. In September of 2009, QFII investment foreign exchange regulations were introduced, and the limit for single-institutions was lifted to US$ 1 billion. The following year, China Securities Regulatory Commission outlined principles for QFII asset allocation distribution. In May of 2011, QFIIs were allowed to participate in stock index futures trading. In August, the RMB Qualified Foreign Institutional Investor (RQFII) system was licensed to pilot in Hong Kong with an initial quota of RMB 70 billion. As a product of China's unique institutional innovation and RMB internationalization, RQFII's birth created new vitality for the development of QFII.

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3. Expansion and loosening in parallel (2012-2017). QFII and RQFII total quotas were increased to US$ 80 billion and RMB 200 billion respectively, in April and December of 2012. Institutional stock ownership limits rose from 20% to 30%. In July of 2013, QFII quota rose to US$ 150 billion. In 2016, upper limits for individual institutions and QFII/RQFII equity allocation ratios were removed, and the lock-up period was shortened to 3 months from one year. In 2017, RQFII quota was expanded to RMB 500 billion.

4. Accelerated institutional optimization (2018 to present). Since last year, the QFII system has been upgraded significantly. In June, the monthly remittance limit and lock-up periods were cancelled at the same time. Risk hedging arrangements and the quota management process became more optimized. After QFII quota was raised to US$ 30 billion in January and IMF obtained RQFII qualification in March, regulators proposed several reform ideas, including merging QFII and RQFII, relaxing access, streamlining application process, shortening time constraints, expanding the scope of investments, and optimizing fund management and risk management. On this basis, the elimination of the three major restrictions of QFII can be described as a matter of course.

II. The role of QFII: opening and reform

In comparison to overseas experience, the role of the QFII system is mainly focused on these three aspects: introducing foreign capital, regulating the market, and promoting reform. The function of QFII in the China market can also be observed from these three aspects:

1. Foreign investors share China's development dividend. After 16 years of QFII operating in China, as of this August, QFII approved amounts reached US$ 111.376 billion, involving 292 institutions. RQFII approved amounts reached RMB 693.302 billion, involving 222 institutions, covering 20 countries and regions. Although there's still room for more quota usage, the overall growth process has been slow and steady.

From the perspective of foreign capital inflows, the participation of foreign investors in China's capital markets continues to rise. In the stock market, major global stock index companies such as MSCI, FTSE Russell and S&P Dow Jones have successively included mainland A shares in their indices and increased their weight, attracting more passive funds and active funds to participate. According to statistics, during the first half of this year, foreign investment in A shares through Stock Connect and QFII reached a total market capitalization of RMB 1.65 trillion, accounting for 2.82% of total market capitalization, a record high. Within this amount, QFII held 293 A share stocks, with market value of RMB 160.456 billion, accounting for 0.6% of total market capitalization.

In the bond market, foreign investment continued to flow under the smooth operation of Bond Connect and the inclusion of China's government and bank bonds into indices from Bloomberg Barclays and JPMorgan Chase. According to information from China Central Depository & Clearing and Shanghai Clearing House, as of this August, foreign capital has increased its holdings of mainland bonds for 18 consecutive months, with a scale of RMB 2.028224 trillion, while the proportion of overseas institutions in the national debt market increased to 8%.

2. The healthy development of financial markets in the Mainland. From the perspective of liquidity, during the operation of the QFII system, foreign capital tends to maintain net inflow, especially in a market downturn. Currently, foreign ownership of China A shares is still relatively low, but continuous inflow reflects optimism towards the medium to long-term views of China's economic growth. From the perspective of market structure, individual investors still accounts for 80% of transactions. QFII, as an important force for medium and long-term strategic investment, plays an important role in promoting the steady rise of institutional investors. In recent years, the overall decline in the turnover rate of Shanghai A shares may have benefited from changes in the market structure and investment philosophy driven by foreign capital inflows.

From the perspective of listed company governance, QFII emphasizes corporate governance structure, dividends, and medium and long-term investment returns, prompting listed companies to regulate management, improve business performance, and emphasize sustainable development. In recent years, the China A share market has seen a number of "white horse stocks" with excellent assets, transparent information disclosure, and complete governance structure, which has become a new force in creating a slow bull market. From the perspective of internationalization, through the QFII scheme and other Connect channels, Mainland market practitioners are becoming familiar with overseas trading methods, learning the management experience, business model, and methods of overseas institutions, while pushing relevant institutional arrangements closer to international standards. The correlation between the A share market and the international market has increased, fostering a dynamic environment for innovative development.

3. Comprehensively deepen financial reform and opening up. The development of QFII is complementary to the financial reforms in the Mainland. Foreign investors were allowed in 2001 to establish a joint-venture securities company. In June of the following year, the launch of M&A transactions and joint-stock business created a favorable policy environment for foreign institutions to enter the A-share market. The Measures for the Administration of Strategic Investment by Foreign Investors in Listed Companies issued in 2005 confirmed the role of foreign capital as a medium- and long-term strategic investor. Subsequently, the Chinese government proceeded with a batch of schemes, such as the Qualified Domestic Institutional Investor (QDII) program, the Shanghai-Shenzhen-Hong Kong Stock Connect, the CDR scheme, the Mutual Recognition of Fund Scheme, and the Shanghai-London Stock Connect, which was launched on June 17 this year. These measures were all used to deepen the financial reform in the Mainland following the QFII.

PBoC allowed central banks, international financial organizations, and sovereign wealth funds to enter the interbank bond market in July 2015. Afterward, the government increased types of qualified overseas investment institutions, broadened the scope and variety of transactions, and initiated the bond connect scheme. These reforms would fasten the development of the bond market. Since the beginning of this year, the Mainland has successively announced 12 new measures for the opening up of the banking and insurance industry and 11 financial opening-up measures, accommodating foreign investment in the Mainland.

With the continuous deepening of financial reforms in the Mainland, capital flows under capital, and financial accounts have contributed more and more to the balance of cross-border capital flows. Among them, the total value of cross-border securities investment in 2018 was US$ 213.7 billion, accounting for 25% of the total amount under capital and financial accounts, up 16 percentage points from 2002. It's more and more important in the Chinese balance of payment. Since the beginning of this year, the balance of bank settlement and sales (including foreign exchange receipts and payments) for securities investment has risen, and in August the net inflows were close to RMB 90 billion. The reform of the QFII system has become an essential part of consolidating the achievements of financial reform and promoting a new pattern of comprehensive opening up.

III. Impact of New QFII Policy: Prospects and Role of Hong Kong

After canceling the three restrictions of QFII, the Chinese authorities indicated that the next step would be a revision of existing regulations to improve the convenience of foreign investors' operation. At the same time, they will adapt to the opening up, effectively prevent cross-border capital flow risks, and maintain economic and financial security. Looking forward, the QFII reform will undoubtedly be beneficial to China's capital market in the long term and exerting a dual positive effect on attracting capital inflows and improvement of the domestic system.

1. Impact and trends. In a short time, the support coming from the QFII reform for the market would be relatively limited. First, there are still a lot of remaining approvals each year. For example, only 31% of the new quota ($70 billion) added at the end of 2015 were used by the end of last year. By Q2 2019, foreign investors held A-shares worth of about RMB 607.8 billion through QFII, accounting for 78% and 29% of the approved quota and total limit respectively. Thus, this reform may not bring short-term capital inflows. The second is that domestic factors are the most critical factors in determining the mainland A-share market. Foreign capital is more "follower" rather than "leader." The last reason is the existence of the Stock Connect Scheme, which can be an alternative to the QFII program. For example, Shanghai-Hong Kong and Shenzhen-Hong Kong Stock Connect Schemes are better than the QFII in terms of currency exchange, fees, and convenience. Foreign investors already using the Stock Connect Scheme are expected to maintain the status quo. Bond investors would make similar choices.

In the medium and long term, the progress of the QFII system will lead to an increase in onshore asset allocations by foreign investors. The market investment entities will be further diversified. The value investing concept with a focus on the medium and long-term strategic development and fundamental research will be widespread. The prospects of internationalization, standardization, and maturity of the bond market are promising. Some institutions estimate that in the next ten years, the annual foreign capital inflow will be in the range of US$ 1,00 to 200 billion. At the same time, the attractiveness of RMB investment products is bound to rise. Besides, QFII's 16 years of experience will also provide a model for lifting restrictions on investment quota with risk control. Other opening-up measures will have room for further optimization.

At the same time, the Chinese government will face a couple of problems with advancing financial reforms. The risks stemming from the inflow of foreign capital comes first. The authority also has to improve the coordination between QFII and other reforms, promote the integration of different mechanisms in operation, and revamp QDII, QDLP (Qualified Domestic Limited Partners), QDIE (Qualified Domestic Investment Enterprise) to further mutual openness.

2. Hong Kong's Role. As an international financial center and an experimental field for the opening of the mainland capital market, Hong Kong has played a leading role in the operation and development of QFII and RQFII. As of the end of August this year, Hong Kong was the primary source of QFII's and RQFII's funds. The RQII approval amount funding from Hong Kong was US$ 25.51 billion, accounting for 22.54% of the total quota, while the RQII approval amount registered in Hong Kong was RMB 345.017 billion, accounting for 49.76% of the total RQFII quota. Under the background that the capital market in the Mainland is not yet fully open, and the financial reform and the opening up are moving forward, Hong Kong will continue to play an essential and unique role in the following three aspects. First, it will continue to attract foreign investors to invest in the Mainland through Hong Kong with the advantages of free access to funds, sharing the economic development achievements of the Mainland; second, it will assist with the progress of the Stock and Bond Connect Schemes for the opening-up of the mainland capital market; and third, it will use the status of the world's largest offshore RMB hub to continue to support the RMB internationalization.

主要經濟指標 (Key Economic Indicators)

一. 本地生產總值 GDP	**2017**	**2018**	**2019/Q1**	**2019/Q2**
總量(億元) GDP($100 Million)	26,628	28,429	7,125	6,987
升幅(%) Change(%)	3.8	3.0	0.6	0.5
二. 對外貿易 External Trade			**2019/7**	**2019/1-7**
外貿總值(億元) Total trade($100 Million)				
總出口 Total exports	38,759	41,581	3,386	22,315
進　口 Total imports	43,570	47,214	3,708	25,083
貿易差額 Trade balance	-4,811	-5,633	-322	-2,768
年增長率(%) YOY Growth(%)				
總出口 Total exports	8.0	7.3	-5.7	-3.9
進　口 Imports	8.7	8.4	-8.7	-5.1
三. 消費物價 Consumer Price				
綜合消費物價升幅(%) Change in Composite CPI(%)	1.5	2.4	3.3	2.7
四. 樓宇買賣 Sale & Purchase of Building Units			**2019/8**	**2019/1-8**
合約宗數(宗) No. of agreements	83,815	79,193	5,159	55,030
年升幅(%) Change(%)	14.8	-5.5	-22.9	-11.3
五. 勞動就業 Employment			**2019/5-2019/7**	**2019/6-2019/8**
失業人數(萬人) Unemployed(ten thousands)	11	10.5	11.9	12.1
失業率(%) Unemployment rate(%)	2.9	2.8	2.9	2.9
就業不足率(%) Underemployment rate(%)	1.1	1.1	1.0	1.0
六. 零售市場 Retail Market			**2019/7**	**2019/1-7**
零售額升幅(%) Change in value of total sales(%)	2.2	8.8	-11.4	-3.8
零售量升幅(%) Change in volume of total sales(%)	1.9	7.6	-13.0	-4.4
七. 訪港遊客 Visitors				
總人數(萬人次) arrivals (ten thousands)	5,847	6,515	519.7	4,006.9
年升幅(%) Change(%)	3.2	11.4	-4.8	11.1
八. 金融市場 Financial Market			**2019/6**	**2019/7**
港幣匯價(US$100=HK$) H.K. Dollar Exchange Rate (US$100 = HK$)	781.4	783.6	781.2	782.7
貨幣供應量升幅(%) change in Money Supply(%)				
M1	9.8	-0.4	-3.6	-0.6
M2	10	4.3	-4.0	3.8
M3	10	4.3	4.0	3.8
存款升幅(%) Change in deposits(%)				
總存款 Total deposits	8.7	5.0	5.0	5.1
港元存款 In HK$	11.6	3.6	3.6	3.4
外幣存款 In foreign currency	5.9	6.4	6.6	7.0
放款升幅(%) in loans & advances(%)				
總放款 Total loans & advances	16.1	4.4	3.3	3.6
當地放款 use in HK	15.5	4.0	3.2	3.6
海外放款 use outside HK	17.4	5.3	3.6	3.5
貿易有關放款 Trade financing	8.7	-7.7	-8.5	-8.7
最優惠貸款利率(%) Best lending rate (%)	5.0000	5.1250	5.1250	5.1250
恒生指數 Hang Seng index	29,919	25,846	28,543	27,778