

HANDS-ON CHINA REPORT
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RMB Internationalization: Evolution of the Offshore Market

Executive Summary

The Renminbi's prominence as a currency for global trading and investment has strengthened since the Chinese government stepped up its internationalization campaign at the height of the global financial crisis. In the past year, China has continued to expand the scope and variety of cross-border RMB business – trade settlements in RMB have risen sharply, the first funds under the Renminbi Qualified Foreign Institutional Investors (RQFII) program have been launched, rules for RMB-denominated FDI and ODI are in place, and the PBoC has now signed currency swap agreements with 18 central banks, valued at over RMB1.6 trillion (most recently with the Reserve Bank of Australia for an RMB200 billion three-year swap agreement). In 2011, about 10% of China's total cross-border trade was settled in RMB compared to only ~2% in 2010.

Nevertheless, the context for Renminbi internationalization has changed somewhat since the start of the year, considering that the value of the currency against the dollar is on course to end Q1 little-changed from its level at end-2011, and that the trend of steady appreciation can no longer be taken for granted. The following report examines the recent trend in “dim sum” product issuance, the expanding suite of products in Hong Kong's offshore RMB market (also known as the CNH market) and elsewhere, and looks at developments in the recently launched Renminbi-denominated QFII (RQFII) program.

- **Expansion of “dim-sum” products continues.** More Chinese companies, especially SOEs and major banks are inclined to issue dim-sum bonds of longer tenor due to the lower cost of financing, even considering increasing yields over the past year. Investors could become more selective towards this asset class, rather than regarding dim sum bonds solely as a play on RMB appreciation. Meanwhile, the issuance of offshore RMB-denominated certificates of deposit increased sharply in early-2012, accounting for 69.5% of all dim-sum products issued since February 1.
- **RMB internationalization enters a new phase of development.** Offshore RMB liquidity should resume growth in the coming months, reflecting the increased proportion of cross-border trade denominated in RMB, as well as RMB-denominated direct investments. However, as the pace of RMB appreciation decelerates, the rate of growth in the overall CNH deposit will be less spectacular in 2012, as compared to the 87% increase in Hong Kong RMB deposits in 2011 and 402% increase in 2010. The available suite of RMB-denominated products will continue to grow more diverse (with offshore RMB loans, RMB-denominated ETFs, stocks and commodity futures currently expected), while alternative offshore hubs, such as London and Singapore, and Taipei will also introduce a variety of RMB products.
- **China is encouraging higher capital inflows through portfolio investment.** The USD2.91 billion QFII quota awarded to 23 institutions thus far in 2012 is already 190% greater than the total amount of quota

granted in all of 2011. Subscription rates for the first batch of RMB-denominated QFII (RQFII) products have been below expectations, likely due to the high degree of similarity across products (which are fixed-income focused) and retail investors' lack of familiarity with the issuers. Licensed RQFII firms are hopeful that demand will be higher as they shift focus towards targeting institutional investors. China's State Administration of Foreign Exchange is said to be considering an increase in the quota ceiling for both the QFII and RQFII programs.

RMB appreciation – no longer a one way bet?

In a recent Reuters poll, the median expectation for CNY/USD appreciation in 2012 was 2.8%, compared to the 4.7% increase recorded in 2011 (J.P. Morgan China economist Haibin Zhu expects the CNY to appreciate against the USD by ~3% in both 2012 and 2013, after which the pace of appreciation is likely to slow markedly). Another survey by Reuters found that in mid-March, traders took short positions on the RMB for the first time since April 2010, with sentiment likely impacted by: i) February data showing the largest monthly deficit (USD31.48 billion) in at least a decade and ii) statements from Premier Wen Jiabao and PBoC governor Zhou Xiaochuan that the RMB is currently trading near an equilibrium level. The PBoC has been trying to promote two-way movements of the currency, and its officials and advisors have recently hinted that the currency's daily trading band against the dollar might be widened from 0.5% to 0.75-1%, which would lead to higher intraday volatility.

I. Expansion of “dim-sum” products continues

The total value of outstanding “dim sum” products in Hong Kong reached RMB292.8 billion in March, amounting to 50% of the territory's total RMB deposit base, compared to merely 13.5% a year ago. Since 2011, more Chinese companies (especially SOEs and large banks) have issued dim sum bonds of longer tenor due to the relatively low cost of financing offshore. In early-2012, the issuance of RMB-denominated certificates of deposits also increased significantly, with major banks in Hong Kong marketing the instruments aggressively.

Dim-sum bonds

In the year thus far, a total of 65 dim-sum bond have been issued, amounting to RMB26.6 billion in total. This represents a quarter-over-quarter increase of 16.9%, or triple the volume issued in 1Q2011. In terms of composition, industrials, banks & financials and governments each accounted for roughly a third of total issuance (see *Figure 1d*). Chinese industrial companies still favor bonds of longer tenor due to the lower cost of financing offshore, even considering yield increases since February 2011 that have brought the average January and February 2012 yield to 5.75% and 5.15%, respectively.

Thus far, dim-sum bonds have been issued by entities in 18 countries and regions (excluding BVI and Cayman Islands). Issuers from China account for 47% of outstanding dim-sum bonds, or as much as two-thirds of the total when including Chinese issuers registered in Hong Kong and elsewhere. Multinational Corporations have been actively issuing dim-sum bonds – in 1Q2012, major MNCs, such as Ford, Caterpillar, Alstom, and America Movil, have issued dim-sum bonds in Hong Kong that were well received by investors – Ford Motor's low-grade (BB-) bond was ten-times oversubscribed.

Figure 1a: Monthly Issuance and cases of dim-sum products

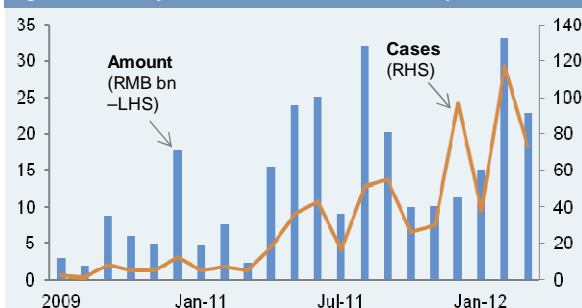


Figure 1b: Duration profile of dim-sum products

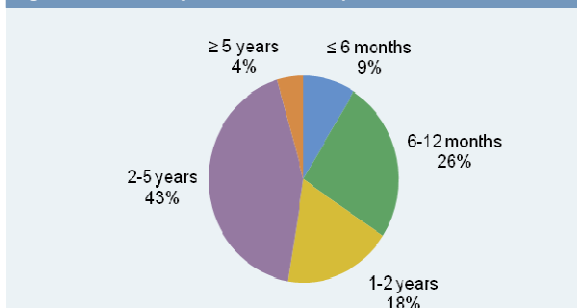
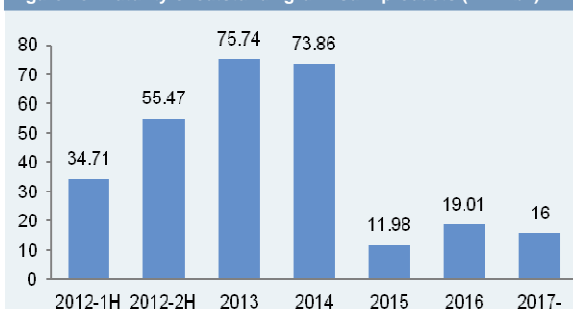
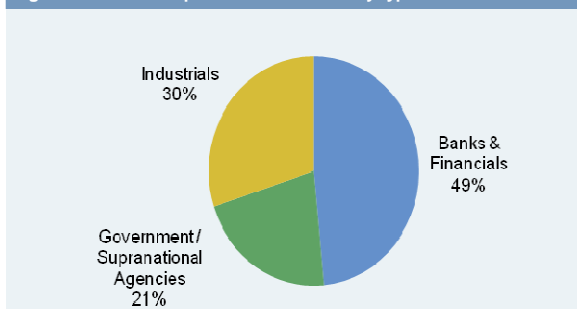


Figure 1c: Maturity of outstanding dim-sum products (RMB bn)



Source: Bloomberg

Figure 1d: Dim-sum products classified by type of issuer



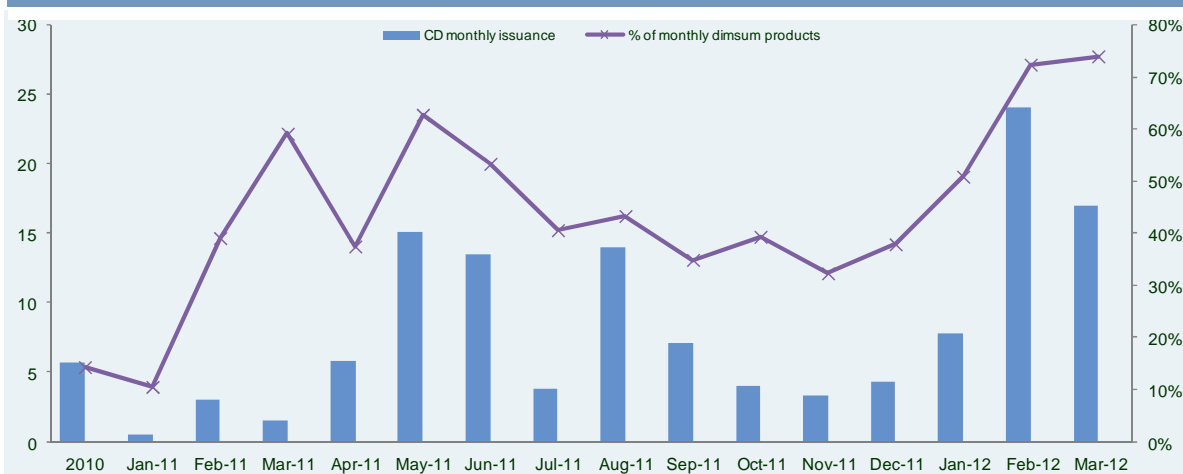
Going forward, dim-sum bond issuance will continue to be an attractive fundraising option for Chinese companies due to the lower financing costs, particularly for Chinese banks seeking to boost capital to fulfill the CBRC's new regulatory requirements. Investors, however, will be presented with a wider array of products, which implies that the high oversubscription rates seen in the past will likely not reoccur. Investors will become more selective towards this asset class, rather than regarding dim-sum bonds solely as a play on RMB appreciation.

The Rise of CDs

The first offshore RMB certificate of deposit was offered by CITIC Bank in July 2010. Since that time, CDs have emerged as a core component of the dim-sum product suite, accounting for 14.3% and 43.8% of total outstanding dim-sum products in 2010 and 2011, respectively. In early-2012, CDs accounted for the majority of the increased value of outstanding dim-sum products – or 69.5% of all dim-sum products issued in February and March. Chinese banks' Hong Kong subsidiaries issued ~80% all offshore RMB CDs, with the rest issued by Hong Kong and multinational institutions. In terms of coupon rates, the average 1-year offshore RMB CD rate declined slightly from 2.78% in January to 2.49% in February.

Since the average RMB time deposit rate is only 1.1% on an annualized basis (for amounts <RMB100k), the investment appeal of CNH CD products is plainly evident. Several factors help to explain the surge of CD issuance in February and March: i) the decline in the CNH deposit base prompted banks to step up their marketing of CDs in their competitions for deposits; ii) more than a third of outstanding CDs will mature in 1H2012, necessitating an increase in issuance; iii) the procedure for CD issuance is more efficient (in both time and cost) than a dim-sum bond issuance.

Figure 2: Offshore RMB CD (RMB billions as a % of total dim sum products)

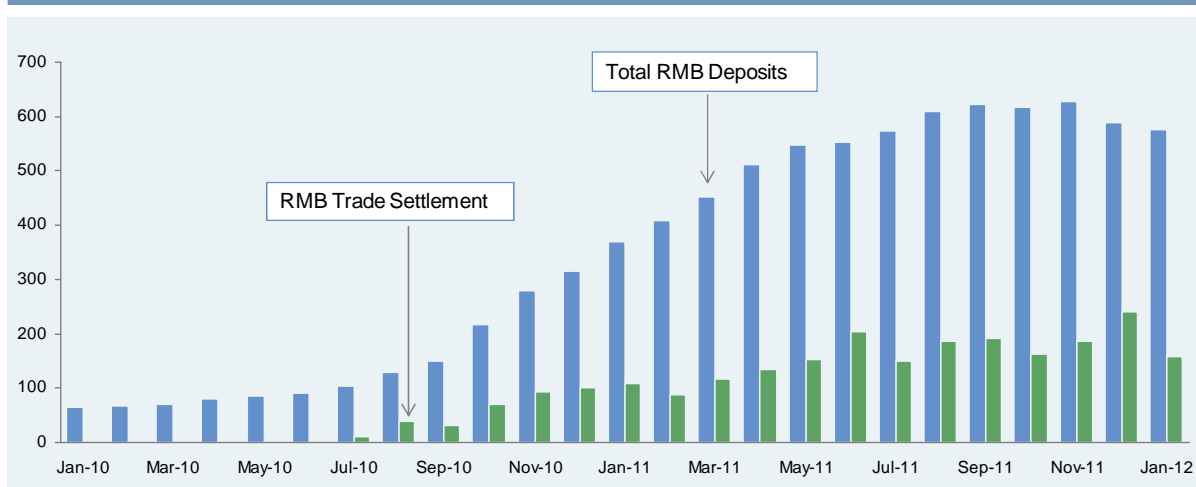


Source: Bloomberg

II. RMB internationalization enters a new phase of development

A decline in the CNH deposit base

Figure 3: Hong Kong RMB Deposits & Hong Kong RMB Trade Settlement (Rmb billions)



Source: HKMA

After climbing nearly 1000% over 25 months of consecutive gains, RMB deposits in Hong Kong have declined for two consecutive months, slipping 6.2% in December and 2.1% in January to reach RMB576 billion, standing at 9.2% of the territory's total deposits (from a peak of 10.4% in September). The decline in the CNH deposit base was likely due to several factors:

- i) Reduced expectations for RMB appreciation – in January, RMB1133.7 billion was converted into HKD and other currencies in Hong Kong, while HKD and foreign currency conversion into RMB amounted to RMB1115.9 billion, implying that there was a net conversion of some RMB17.8 billion from the Renminbi into other currencies during the month.
- ii) A decline in trade settlement as a result of the early timing of the Chinese New Year holiday and a slowdown in growth of Chinese exports (-0.5% YoY in January). Hong Kong's total exports to China declined by 9.7% MoM in January, while total remittance of the RMB through

Hong Kong for cross-border trade settlement amounted to RMB156.4 billion, compared with RMB239 billion in December.

- iii) An expansion of investment opportunities and repatriation channels. In January, the volume of RMB flowing into Hong Kong under the trade settlement scheme exceeded outbound flows, suggesting that the CNH deposit base should have increased, if not for other factors. During the month, total issuance of dim sum bonds exceeded RMB8.2 billion and issuance of CDs reached RMB7.8 billion, compared to RMB7.9 billion in bond issuance and RMB4.3 billion in CD issuance in December.

As *Figure 4* shows, the CNY and CNH exchange rates have shown a greater tendency to converge as the RMB-denominated trade and investment channels between the Mainland and Hong Kong jurisdictions expand. In Q311, Bank of China Hong Kong, the territory's only clearing bank exhausted its trade settlement quota and suspended transactions, causing the CNH rate to weaken sharply in September.

Figure 4: USD spot exchange rates vs. CNY & CNH



Source: Bloomberg

RMB trade settlement scheme expanded to cover all companies

The Renminbi trade settlement scheme has grown to account for about 10% of China's total cross-border trade conducted in 2011, with 92% of the total settlement volume occurring via Hong Kong. The RMB's share of trade settlement volumes will receive a further boost from the release of new rules earlier this month (issued jointly by the PBoC, the Ministry of Commerce, the Ministry of Finance, as well as China Customs, CSRC and the State Administration of Taxation) that effectively expands the RMB cross-border trade settlement program to cover all enterprises licensed to conduct foreign trade. Although the scheme had already been expanded in July 2010 to cover the whole nation, eligibility for export tax rebates under RMB cross-border settlement was previously restricted to 67,742 designated enterprises.

RMB-denominated ODI and FDI

In the past year, China has further opened its capital account by broadening the scope for RMB-

denominated FDI and ODI. Following the announcement of a trial program for RMB-denominated ODI for non-financial enterprises in early-2011, the volume of RMB ODI last year amounted to RMB20.2 billion. In November, new regulations announced by the PBoC and MOFCOM lifted restrictions on the use of offshore RMB for FDI, providing a new channel through which RMB can flow back into China. While RMB-denominated FDI was previously permitted on a case-by-case basis for projects relating to a company's ongoing operations, under the new regulations, local-level MOFCOM branches may now authorize approval for most investments that are less than RMB300 million in amount.

Central MOFCOM approval, however, is still required for investments made in certain financial sectors, in highly-regulated sectors (such as cement, iron and steel or ship building), and investments made to establish a foreign invested holding company, a foreign invested equity investment enterprise or a foreign invested venture capital enterprise. In January and February, RMB25.1 billion in RMB-denominated FDI was recorded, as compared to RMB90.7 billion in FY2011.

Future Steps to Globalize the RMB

Despite the recent dampening of momentum in CNH deposit growth, we expect the scale and volume of cross-border RMB activity to continue increasing in 2012, with further product innovation and liberalizations on the horizon:

- **Offshore RMB loans.** In early-January, the National Development and Reform Commission (NDRC) allowed Guangdong Nuclear Power Group to borrow RMB3 billion from Bank of China in Hong Kong, marking the first time that a Mainland company has borrowed RMB directly from an offshore bank. Domestic Chinese media has reported that the Guangdong branch of the PBoC is now considering a plan to allow companies in the province to borrow RMB from Hong Kong and remit the loans back. According to a Reuters report, the initial quota for the plan is reported to be around RMB30 billion.
- **RMB-denominated ETFs.** Another development that signaled a new channel of investment for CNH was the launch of the first RMB-denominated ETF listed on the Hong Kong Stock Exchange – Hang Seng Bank's RMB-denominated gold ETF, which tracks the London gold fixing price.
- **RMB commodity futures.** The Hong Kong Mercantile Exchange (HKMEx) is planning to launch RMB-denominated gold futures by July 2012, as well as RMB-denominated contracts for copper and other industrial metals within the next 12 months.
- **RMB settlement of commodity trades.** The Chicago Mercantile Exchange (CME) and Bank of China have signed an agreement to expand the use of RMB in settling some commodity trades and to enhance cooperation on RMB clearing, custody and futures settlement. Since January, CME group has begun accepting offshore RMB as collateral on its exchange-traded futures products (up to a cap of USD100 million).
- **RMB-denominated stocks in HK.** The stock exchange of Hong Kong launched its RMB Equity Trading Support Facility in October 2011 to enable secondary trading of RMB-denominated equities, however the uncertain market sentiment has delayed the issuance of the first RMB-denominated equities.

- **Relaxing capital controls for individuals?** In its Q4 monetary policy report released in mid-February, the PBoC said it plans to "explore cross-border yuan business for individuals."

Alternative offshore RMB hubs

According to a host of recent reports, London, Singapore, Taipei and Dubai are among global cities vying for a share of the offshore RMB business. During a visit to China in January, British Chancellor of the Exchequer George Osborne announced plans to build London into a major international trading center for RMB and the *Wall Street Journal* has recently reported that banks in the U.K. are lobbying the Bank of England to sign a currency swap agreement with the PBoC, which could help to support trade settlement and increase London's RMB deposit base. Currently, three Chinese policy banks – China Development Bank, Export-Import Bank of China and Agricultural Development Bank of China are reportedly preparing to issue the first offshore Renminbi bonds to be listed on the LSE, targeted at the European investor base.

Reuters also recently reported that the Dubai International Financial Centre may permit RMB transactions this year; trade between China and the UAE expanded 39% YoY to USD32 billion in 2011.

In late-January, Taiwan approved the Bank of China and Bank of Communications to remit funds from the Mainland to their Taipei offices, while Taiwan's Financial Supervisory Commission has asked Chinese regulators to permit six state-controlled banks to conduct business in RMB. Meanwhile, deputy PBoC governor Hu Xiaolian reportedly indicated at a recent press conference that the Chinese government is considering accelerating the implementation of a cross-Straits currency-clearing program under an agreement signed in July 2010. During the first quarter board meeting of Taiwan's central bank, Governor Perng Fai-nan indicated that a clearing agreement with the Mainland is likely to be signed before mid-2012.

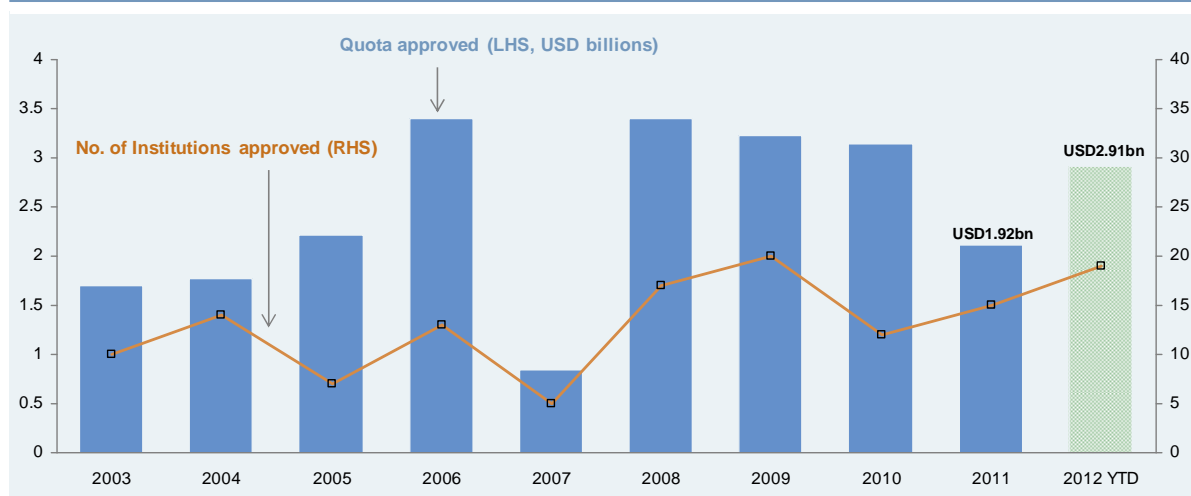
III. China is encouraging higher capital inflows through portfolio investment.

Portfolio investments in China's securities markets are only permitted through: i) Qualified Foreign Institutional Investors (QFII) who have received a license from the securities regulator and obtained a quota from the State Administration of Foreign Exchange (SAFE), ii) The recently-launched RMB-settled variant of the QFII program known as "RQFII", which allows Hong Kong subsidiaries of PRC securities or fund management firms to invest offshore RMB funds into the Chinese fixed income and A-share equities market.

QFII - Accelerated Quota Approval

The government's recent approach towards this conduit has shown a strong bias towards encouraging higher capital inflows. In the context of lackluster A-share market performance and consecutive monthly reductions in China's foreign exchange purchases, the QFII approval and quota allocation process has been expedited in recent months (see *Figure 5*). SAFE has indicated that it has granted investment quotas of USD2.91 billion in total to 23 QFIIs in the year-to-March 9, as compared to USD1.92 billion for all of 2011. A recent report in the *China Securities Journal* cited SAFE director Yi Gang as saying that an increase in the overall QFII quota is under review. China last increased the ceiling for the QFII program to \$30 billion from \$10 billion in 2007.

Figure 5: License approval and quota allocation for China's QFII program



Source: SAFE

Shanghai is also said to be planning to introduce the QFII program in local futures, gold and derivatives markets during the period from 2011-15. The move has been outlined in the latest plan for Shanghai's foreign investment published on the Shanghai Municipal Development and Reform Commission website earlier this month.

RMB Qualified Foreign Institutional Investors (RQFII) – Initial Fundraising Falls Short of Expectations

After much anticipation, the China Securities Regulatory Commission (CSRC) issued rules for the RQFII scheme on December 16, with the initial quota ceiling for the program set at RMB20 billion (see Figure 6 for a timeline of the RQFII program's development). As expected, the RQFII rules require a minimum 80% allocation to fixed income and cap the amount of equities held in a fund at 20%, meaning that RQFII products are primarily fixed income funds. To date, 21 financial institutions have received quota, including the Hong Kong subsidiaries of some of China's largest asset management companies (see Figure 7).

With investor appetite for "dim sum" products having been strong in 2011, RQFII products were expected to receive healthy levels of demand. However, fundraising efforts so far have generally fallen short of expectations, with local news reports suggesting that fund managers have only been able to fill orders for about half of their quota. The likely reasons for the lackluster performance include: i) a high degree of similarity across the first batch of products, ii) a focus on targeting retail investors, who were unfamiliar with many of the asset management firms offering the funds, iii) possible concern about the credit rating of mainland bond issuers (considering that most mainland bonds are unrated by international agencies), iv) many of the first products were also launched close to the Chinese New Year period.

Going forward, RQFII managers are likely to shift their fundraising focus towards targeting the institutional market, where demand is believed to be stronger than among retail investors. The CSRC has stated that it intends to gradually expand the scale of the RQFII pilot program and increase its investment quota. The CSRC is also reportedly considering Taiwan as a second destination for the RQFII program.

Figure 6: Timeline: RQFII development and implementation

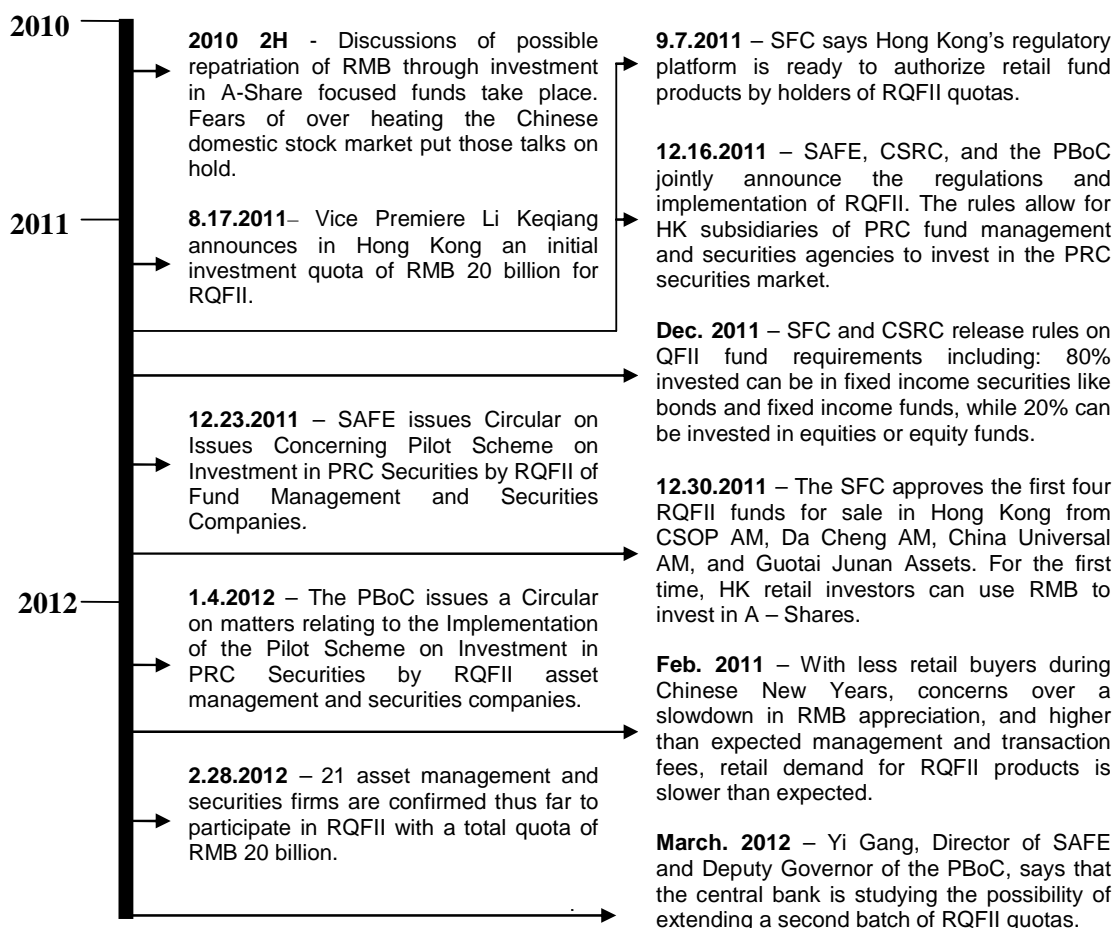


Figure 7: Approved RMB Qualified Foreign Institutional Investors (RQFII) and quota amount

Company	Quota RMB billion
China Asset Management (Hong Kong) Ltd.	1.2
CSOP	1.1
E Fund Management Company Ltd.	1.1
Harvest Fund	1.1
China Universal Asset Management Company	1.1
Da Cheng International Asset Management Co. Ltd..	1.1
HFT Investment Management Co. Ltd.	1.1
Bosera Funds	1.1
HuaAn Asset Management Company Ltd.	1.1
CITIC Securities International Company Ltd.	0.9
GF Securities	0.9
Haitong International Holdings Ltd.	0.9
China Merchants Securities (HK) Co. Ltd.	0.9
China Everbright Financial Holdings Ltd.	0.9
Essence International Financial Holdings Ltd.	0.9
Shenyin Wanguo Securities Group Co.	0.9
Guotai Junan Securities	0.9
Guosen Securities Financial Holdings Co. Ltd.	0.9
CICC (HK) Ltd.	0.9
Huatai Financial Holdings (HK) Co.Ltd	0.5
GY (HK) Securities Co. Ltd.	0.5
TOTAL	20

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